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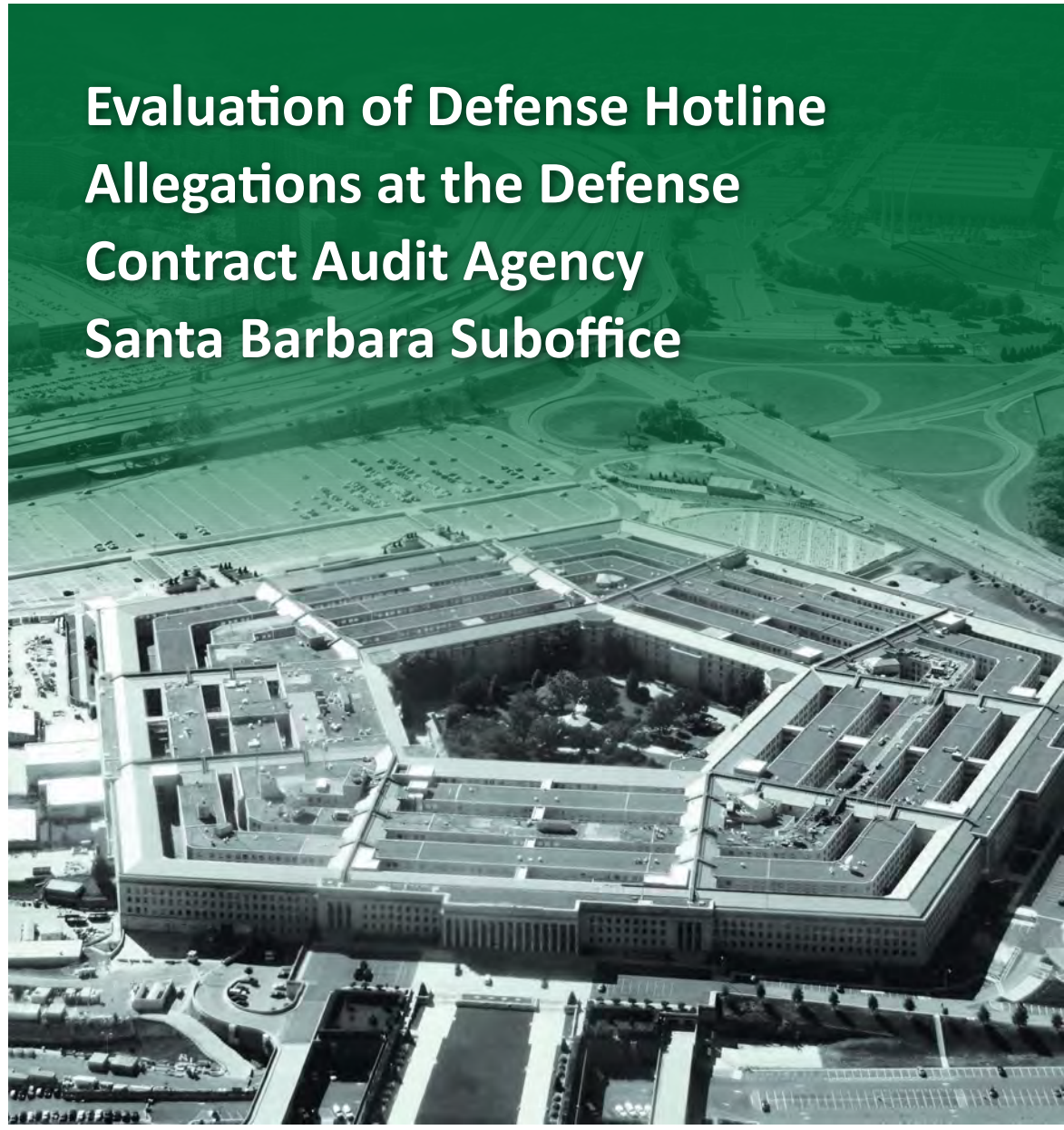
INSPECTOR GENERAL

U.S. Department of Defense

OCTOBER 8, 2014



Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice



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Vision

Our vision is to be a model oversight organization in the Federal Government by leading change, speaking truth, and promoting excellence—a diverse organization, working together as one professional team, recognized as leaders in our field.



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Results in Brief

Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice

October 8, 2014

Objective

We reviewed Defense Contract Audit Agency (DCAA) San Fernando Valley Branch Office (Branch Office) Santa Barbara Suboffice (Suboffice) audit documentation for 19 audit assignments and 1 paid voucher review identified by the complainant in the allegations. During the review, we visited the Suboffice and interviewed the complainant, auditors, supervisors, and managers to assess whether the problems identified concerning the performance of audit work existed.

Findings

We substantiated 4 of 20 allegations that:

- unallowable cost for legal fees and suspected fraud were not reported;
- time and material vouchers were excluded from a paid voucher review;
- a supervisor did not support an auditor's request for a listing of contractor Employee Stock Ownership Plan participants; and
- work performed under a floor check audit did not support the auditor's conclusions.

We partially substantiated 5 of 20 allegations that:

- an incurred cost audit report was issued without an adequate submission that included unallowable costs;

Findings (cont'd)

- the Western Region was not responsive to an auditor's request for audit guidance;
- incurred travel costs were not adequately reviewed;
- pricing actions were not selected for postaward audit; and
- incurred cost audits do not identify contractor documents reviewed.

Recommendations

We recommend that DCAA:

- rescind two audit reports and one memorandum on a paid voucher review;
- review and assess the adequacy of audit coverage at the San Fernando Valley and Central Coast Branch Office;
- review certain incurred costs audits to ensure sufficiency of testing to support report opinions;
- review management and staff performance on incurred costs and floor check audits over a 5-year period; and
- increase defective pricing audit coverage and perform a separate risk determination for (b) (4) during the defective pricing selection process.

Management Comments and Our Response

The Deputy Director, DCAA, generally agreed with our findings and recommendations and has taken corrective actions. Many of the identified deficiencies were already addressed in response to a Preliminary Results Memorandum issued prior to the draft report. This report is being issued to address DCAA comments on the draft report, update corrective action taken, and close out the case with Defense Hotline. Therefore, no additional comments are required. Please see the recommendations table on the following page.

Recommendations Table

| Management | Recommendations Requiring Comment | No Additional Comments Required |
|---|--------------------------------------|---|
| Director, Defense Contract Audit Agency | | A.1.a-f, C.1.a and b, D.1.a-e, F.1.a-h, G.1.a-e |
| Regional Director, Northeast Region | | D.2.a and b |
| Regional Director, Western Region | | A.2.a and b, C.2.a-d, E.1.a-c, E.2.a and b |
| Branch Manager, Central Coast Branch Office | | A.3.a-g, B.1, B.2, B.3, B.4, B.5.a-c, D.3.a-e, F.2.a-c, G.2.a and b |
| Resident Auditor, (b) (4) Resident Office | | F.3.a-c |



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500**

October 8, 2014

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency
Santa Barbara Suboffice (Report No. DODIG-2015-005)

We are providing this final report for your information and use. We reviewed a Defense Hotline complaint from the Santa Barbara Sub Office and substantiated or partially substantiated allegations regarding flawed audit work. Specifically, failure to comply with generally accepted government auditing standards and DCAA policies and procedures related to audit planning, evidence, supervision, reporting, and overall audit quality.

Final report issuance was substantially delayed due to the shift in our review of Defense Hotline allegations to our primary oversight of DCAA audit quality. However, DCAA completed many of the corrective actions in 2011 in response to the Preliminary Results Memorandum we issued.

We considered management comments on a draft of this report when preparing the final report. Comments from Defense Contract Audit Agency conformed to the requirements of DoD Directive 7630.3; therefore, we do not require additional comments.

We appreciate the courtesies extended to our staff. Please direct questions to Ms. Carolyn R. Davis at (703) 604-DoD
OIG: (b) (DSN 664-DoD OIG:
(b) (6)).

A handwritten signature in black ink, appearing to read "R. Stone", is positioned above the name of the Deputy Inspector General.

Randolph R. Stone
Deputy Inspector General
Policy and Oversight

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Acronyms and Abbreviations

Introduction

Objective

We conducted this review to assess whether the DoD Hotline allegations regarding the adequacy of audit work performed and other related issues at the Defense Contract Audit Agency (DCAA) San Fernando Valley Branch Office (Branch Office) Santa Barbara Suboffice (Suboffice) have merit. See Appendix A for a discussion of our scope and methodology.

Background

In August 2008, the Defense Hotline received a complaint alleging that audits performed in FYs 2005 through 2008 at the Suboffice often times did not comply with generally accepted government auditing standards (GAGAS). The complaint identified specific problems with several audit assignments, overall audit office programming and planning of audits, and made several miscellaneous allegations.

Preliminary Results Memorandum

We issued Audit Policy and Oversight (APO) Memo No. 2010-CAPO-0107-06, "Evaluation of Defense Hotline Allegations at the DCAA Santa Barbara Suboffice," on September 30, 2010, reporting 13 issues and 1 overall finding identified during our Hotline review which resulted in 54 recommendations made to various levels of DCAA management. DCAA provided a formal response to the subject Memorandum on December 22, 2010, and generally agreed with 9 issues and agreed in principle or partially agreed to 46 of the 54 recommendations. DCAA provided corrective actions and suspense dates for each agreed-to recommendation. For the remaining 4 issues, DCAA provided clarifying information or only partially agreed with our finding. DCAA comments to the Preliminary Results Memorandum, as well as additional information provided by the complainant, were evaluated in preparing this report.

Prior Review Findings and DCAA Corrective Actions

Prior Government Accountability Office (GAO) and Inspector General (IG) reviews of other DCAA Western Region audit offices have identified significant deficiencies in audit work, including poor supervision, inadequate documentation, inappropriate changes to report opinions, and lack of sufficient testing to support report opinions.¹ DCAA implemented various corrective actions such as revised supervisory training

¹ Appendix A, Prior Coverage, contains a full listing of all reports issued during the last 5 years.

and a required computer-based training course on working paper documentation to address audit quality at the Suboffice as well as other DCAA audit offices. According to DCAA, they have taken the following five corrective actions:

1. All employees completed working paper training provided by the Western Region Technical Programs Division in March 2009.
2. All audit staff completed the Defense Contract Audit Institute Course No. 1269, "Working Paper Documentation Training," during the first quarter of FY 2010.
3. All audit staff obtained training on incurred cost submission adequacy by January 2011.
4. All audit staff completed the Defense Contract Audit Institute Course No. 1140, "GAGAS Training," during the fourth quarter of FY 2010.
5. DCAA issued new policy on variable and attribute sampling on August 31 and October 20, 2011, respectively, and auditors completed training modules by January 31, 2011.

We will review the sufficiency of the corrective actions taken or planned by DCAA at a future date.

Defense Contract Audit Agency

Charter

In 1965, DCAA was formed to provide a single contract audit capability within the Department of Defense. DoD Directive 5105.36, "Defense Contract Audit Agency," provides the mission, organization and management, responsibilities and functions, relationships, and authorities of the DCAA. DCAA is a Defense agency under the direction, authority, and control of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. The primary mission of DCAA is to perform contract audits for DoD. DCAA also provides accounting and financial advisory services regarding contracts and subcontracts to DoD Components responsible for procurement and contract administration. In addition, DCAA performs contract audit services for non-DoD Federal organizations on a reimbursable basis, as appropriate.

DCAA Organization and Functions

In FY 2011, DCAA consisted of approximately 4,725 people located in 114 field offices throughout the United States, Europe, Pacific, and Southwest Asia. DCAA consists of Headquarters, five regions, and Field Detachment (for classified audits). Regional directors are responsible for planning, managing, and accomplishing the DCAA mission in assigned geographical areas including personnel and resources in the individual regional offices and various field audit offices within their region. The Field Detachment director has the same responsibility for worldwide DCAA contract audits of compartmented programs and the personnel and resources assigned to Field Detachment. DCAA audits forward pricing proposals submitted by contractors and subcontractors in connection with award, administration, modification, or re-pricing of Government contracts.² DCAA audits also help contracting officers determine the adequacy of a contractor's estimating, budgeting, billing, and accounting systems; compliance with the cost accounting standards and disclosed accounting practices; and allowability of incurred costs charged to the Government in accordance with the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS).

Incurred Costs Audits

DCAA performs an incurred cost audit to examine the contractor's annual submission and to express an opinion as to whether the claimed incurred costs are reasonable, applicable to the contract, determined applicable under Generally Accepted Accounting Principles and Cost Accounting Standards, and not prohibited by the contract, statute, regulation, or previous agreement with the contracting officer. Contractors are to submit to the contracting officer and DCAA auditor an incurred cost submission six months after the end of the contractor's fiscal year. Incurred cost audits are usually performed annually for contractors with greater than \$15 million of auditable costs. Contractors with \$15 million or less of auditable costs each year are either subject to a full audit or a desk review. High risk contractor³ submissions are audited every three years. For the other two years, DCAA performs a desk review of the submission.

² Forward pricing proposals are audits of estimated future costs of proposed contractor pricing, proposed contract change orders, costs for re-determinable fixed-price contracts, and costs incurred but not yet covered by definitized contracts.

³ A contractor is considered high risk when the contracting officer identifies significant risk associated with the submission, if two consecutive fiscal years have been closed out using desk review procedures, or there is no prior experience with the contractor.

Santa Barbara Suboffice

The Suboffice, located in Goleta, CA, was a subordinate element of the Branch Office under the cognizance of the Western Region for the time period covered by the complaint.⁴ The Suboffice conducts audits at several non-major contractors within an assigned geographical area and is dependent on the Branch Office for issuance of audit reports and other administrative support. The Suboffice staff consisted of one supervisor and six senior auditors during the time period covered by this review. Suboffice auditors performed various types of contract audits, including incurred cost audits and forward pricing proposal reviews.

Generally Accepted Government Auditing Standards

DoD Instruction 7600.02 dated April 27, 2007, "Audit Policies," requires that all independent audit and attestation engagements of DoD organizations, programs, activities, and functions be conducted in accordance with GAGAS as issued by the Comptroller General of the United States. GAGAS provides the framework for auditors to perform high-quality audit work with competence, integrity, objectivity, and independence. Under GAGAS, auditors must prepare audit documentation in sufficient detail to provide a clear understanding of the work performed, including the nature, timing, extent, and results of audit procedures performed; the evidence obtained and its source; and the conclusions reached. The audit documentation should contain support for the report's findings, conclusions, and recommendations.

⁴ Effective April 25, 2010, the Suboffice became part of the newly established Central Coast Branch Office which is also in the Western Region. The Central Coast Branch Office was deactivated in February 2012 and the Suboffice was transferred back to the Branch Office; however, incurred cost assignments related to contractors under Suboffice cognizance became the responsibility of the LA/Orange County North Incurred Cost Audit Team.

Finding A

Unallowable Legal Fees Discovered and Not Reported in an Incurred Cost Audit (Allegation 9)

We substantiated the allegation that to meet performance metrics, the Suboffice:

- did not report questioned unallowable legal fees identified under Assignment No. 4231-2004P10100013, Audit of (b) (4) FY 2004 Incurred Cost, and
- failed to address fraud indicators in the audit and make a fraud referral.

The Suboffice issued a flawed audit report just 10 days prior to the performance metric deadline. According to the working papers, the auditor identified unallowable legal fees during the audit, but did not include the questioned cost in the report. The auditor also failed to identify obvious fraud indicators. Additionally, the auditor gathered insufficient evidence to support the report opinion that the claimed costs were allowable for reimbursement purposes and failed to identify certain costs as expressly unallowable and subject to penalty.⁵ Therefore, the Government reimbursed the contractor at least \$ (b) (4) in unallowable indirect costs and could have reimbursed additional unallowable direct or indirect costs which the audit failed to identify. Also, when fraud indicators were identified, the auditor should have, but did not expand his/her audit steps and procedures as required by GAGAS and DCAA policies and procedures. The auditor should have also considered making a fraud referral. Therefore, the Suboffice failed to perform its primary fiduciary responsibility of protecting the Government and taxpayer interest.

⁵ An expressly unallowable cost is a particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable.

Reporting Questioned Unallowable Costs

Allowability of Legal Fees

Of the \$(b)(4) in claimed accounting and legal fees, the auditor identified \$(b)(4) of unallowable costs, but did not question the costs in the report. The unallowable legal fees included \$(b)(4) for patent applications and registration filings that were not contractually required and, therefore, expressly unallowable per FAR 31.205-30(c) "Patent Costs" and subject to penalty as required by Title 10 United States Code § 2324, "Allowable costs under defense contracts." The remaining \$(b)(4) of unallowable legal fees was for a contractor (b)(6) that were unallowable per FAR 31.201-4(c), "Determining Allocability," because the costs were not necessary to the overall operation of the business nor were they directly chargeable to a specific contract or other cost objective. Additionally, \$(b)(4) of the \$(b)(4) (b)(6) were out-of-period costs which also made them unallowable.

Supervisory Review

(FOUO) The supervisory guidance concerning the questioned legal fees did not demonstrate good professional judgment. The supervisor stated in the final review comments that the auditor should either include the questioned legal fees in the audit report or "correct" the working papers. The supervisor approved the working papers and the report even though the auditor did not report the legal fees as unallowable. This resulted in the 2004 general and administrative rate being overstated by 1.43 percent which increased the total contract costs accepted by approximately \$(b)(4). The supervisor should have explained to the auditor that the questioned legal fees for the patent were expressly unallowable and needed to be included in the audit report. The auditor noted on the summary working paper that the audit-determined rates and cost impact were based on findings; however, this statement is inaccurate since the auditor failed to exclude the questioned legal fees from the general and administrative pool during the calculation of the rate.

Requirements for Identification of Potential Fraud

The auditor documented the unallowable legal fees as a potential fraud indicator; however, the auditor did not consider whether additional testing was required by GAGAS, or whether a fraud referral should be issued. Because the expressly unallowable legal fees directly related to a (b)(6) the auditor and the supervisor should have discussed making a fraud referral and documented the discussion

and its conclusion in the working papers. Additionally, the auditor and supervisor should have reassessed the risk and considered expanding testing for both direct and indirect cost accounts. On December 9, 2009, we issued a fraud referral to the Deputy Inspector General for Investigations on the unallowable legal fees. Dependent on the (b) (4) decision on abrogating the 2004 indirect rate settlement agreement so the costs can be recouped, we will pursue appropriate additional administrative remedies.

Audit Deficiencies and Performance Metrics

Insufficient Evidence

(FOUO) The auditor did not gather sufficient evidence to opine on the claimed indirect costs and direct cost elements such as direct labor, direct materials and other direct costs, as required for an incurred cost audit. The auditor should have tested the direct accounts because the direct costs made up over 50 percent (\$DCAA: (b) (4) of \$DCAA: (b) (4)) of the auditable claimed costs. Additionally, the auditor only tested one indirect cost account - legal and accounting fees. Based on the results of the testing described above, the auditor should have tested other sensitive accounts such as auto expenses, meals, outside services, rent, travel, or business development. Therefore, the auditor failed to obtain sufficient evidence to support the report opinion and the supervisor failed to identify the deficiencies and have them corrected prior to report issuance. The audit staff displayed a serious lack of professional judgment in performing this audit. The flawed audit allowed the contractor to be inappropriately reimbursed unallowable costs of at least \$DCAA: (b) (4) and potentially more given the lack of sufficient testing.

Adjustment to Allocation Bases

(FOUO) The auditor failed to exercise professional skepticism when reviewing labor and unclaimed overhead costs charged to an inventory account and, therefore, did not perform any independent review of the somewhat unusual charges. The auditor also did not adequately document the information gathered on the charges or the review performed. The auditor reviewed an adjusting journal entry made at year-end that involved moving direct commercial labor costs and unclaimed overhead costs to an inventory account, thereby inappropriately removing the costs from the indirect allocation bases. As a result of the understated allocation bases, the indirect rates were overstated and the contract was overcharged for indirect costs. The auditor determined that the overhead allocation base should be adjusted by \$DCAA: (b) (4) for the commercial labor costs and the general and administrative allocation base by \$DCAA: (b) (4) for the unclaimed overhead costs. However, the auditor should have

performed more testing to determine the actual nature of the transferred costs and should have recognized the transaction as a potential fraud indicator or risk factor. These identified risk factors would have required the auditor to consider additional testing for similar or related transactions. Additionally, on at least one subsidiary working paper, the auditor described offsetting the indirect base adjustments with the unallowable legal fees. Both the adjustment to the indirect allocation bases and removing the unallowable legal fees from the indirect pool costs would lower the indirect rate. Therefore, the two items cannot be used to 'offset' each other.

Effect of Performance Metric

The significant deficiencies in the audit, including the lack of professional judgment, could have resulted from the audit staff trying to meet the 24-month performance metric for issuing an incurred cost audit report. The contractor gave its submission to DCAA on September 30, 2005, but the auditor did not start the audit until April 6, 2007 - approximately 18 months after receiving the submission. On September 10, 2007, the auditor completed a working paper adjusting the overhead allocation base for commercial labor costs inappropriately excluded and the general and administrative allocation base for the excluded unclaimed overhead costs. To perform additional testing of direct and indirect costs, it would have taken at least two weeks, if not longer, depending on the availability of the supporting documentation. Instead of performing more testing, during the September 12, 2007 exit conference, the auditor discussed with the contractor the adjustments to the overhead and general and administrative bases, and the impact on the indirect rates, but not the questioned legal fees. On September 17, 2007, the auditor turned in the audit file and report for supervisory review. The draft report did not question the (b) (6) or patent cost legal fees. Three days later, the supervisor reviewed the audit file and report, gave the report back to the auditor with corrections to be made, cleared the auditor's corrections, and issued the report. The Suboffice issued the report on September 20, 2007, 10 days before the 24-month performance metric deadline. To include the questioned legal fees in the report would have required the auditor to re-coordinate that finding with the contractor. Revising the report and the additional coordination would have delayed the report issuance, resulting in the Suboffice missing its deadline.

DCAA Revised Metrics

Recognizing that certain performance metrics could negatively impact audit quality, DCAA eliminated the 24-month incurred cost audit performance measure along with 17 others on September 30, 2008. Instead, DCAA developed eight new performance

metrics to emphasize quality audit work. DCAA also established a Web site for employees to report the inappropriate use of performance metrics. To date, we have not evaluated the appropriateness of the new performance measures or their impact on audit quality.

DCAA Response to Preliminary Results Memorandum

DCAA generally agreed with the issues identified and agreed or partially agreed with 9 of 10 recommendations. DCAA agreed that the audit did not test direct costs, tested only one indirect cost account, did not report unallowable legal costs, and that a fraud referral should have been made. A preliminary DCAA review of the FY 2005 incurred cost audit identified similar issues and DCAA did not believe that a quality assurance review of the FY 2006 incurred cost desk review was appropriate since it was not performed in compliance with GAGAS. DCAA agreed to perform additional testing of the claimed direct costs for FYs 2004 and 2005. DCAA will perform additional testing of indirect costs for FYs 2004 and 2005 if (b) (4) agrees to reopen the negotiated indirect rate agreements. DCAA declined to reopen the desk review and audit the FY 2006 (b) (4) incurred costs because the contractor only had one open contract in that year and it was overrun by \$DCAA: (b) (4). DCAA agreed to reconsider its decision if the additional testing performed on FYs 2004 and 2005 incurred costs results in significant additional cost questioned.

DCAA agreed to review the performance of the auditors involved in the (b) (4) audit, provide them additional training and take appropriate actions to correct any identified performance deficiencies. DCAA partially agreed with performing quality assurance reviews on all 54 incurred cost audits and desk reviews performed by the same auditor and supervisor in the last 5 years. For the FYs 2003 and 2005 (b) (4) incurred cost audits, DCAA will perform a quality assurance review if it identifies a way to recoup any additional costs that could be questioned by additional testing. For the 15 audits where the contractors have no currently auditable contracts, if DCAA determines that contracts from the prior periods are still open, DCAA will perform quality assurance reviews of those audits to determine whether additional testing is needed. For 35 audits, DCAA will perform full audits instead of desk reviews at those contractors that have contracts currently subject to audit. If significant issues are found, DCAA will determine whether it is worthwhile to perform additional testing in the prior years.

Recommendations, Management Comments, and Our Response

Recommendation A.1

We recommend that the Director, DCAA, provide to this office written products documenting:

- a. The headquarters review of the FY 2003 and FY 2005 (b) (4) [REDACTED] incurred cost audits and any resulting actions taken.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA provided Memorandum Q 225.4, "Integrity and Quality Assurance Directorate's Recommendation to the Director, Western Region," dated June 30, 2011. As a result of its review, DCAA rescinded both the 2003 and 2005 audit reports on July 11, 2011.

Our Response

The comments from DCAA are responsive. No further action is required on this recommendation.

- b. The analysis of the next incurred cost audit performed at the 22 contractors that have auditable contracts ongoing. The product should also explain whether additional testing was performed in prior years' audits based on the findings from the current year audit.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA will perform an audit, rather than desk reviews, of the next open contractor fiscal year incurred cost submission at each of the 22 contractors that have ongoing flexibly-priced contracts. If DCAA determines that significant issues identified during these audits existed in prior years, they will perform additional testing if the cost-reimbursable contracts have not yet been closed. DCAA provided the analysis of the 22 contractors with estimated audit due dates.

Our Response

The comments from DCAA are responsive. The DCAA audit office issued reports for 19 of 22 contractors. DCAA also closed three contractors' incurred cost audits with no report issued because one contractor was transferred to the Utah Branch Office, one had no auditable contracts, and one was placed in the low-risk incurred cost sample pool due to new risk criteria.

- c. The analysis of the eight contractors that have no current auditable contracts to determine whether contracts are still open that were audited in prior years.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA provided the analysis of the eight contractors that no longer have current auditable contracts. DCAA determined that five of the eight contractors still had open contracts with significant unsettled costs and assessed the quality of the audits at these contractor locations. The DCAA headquarters quality assurance review noted significant deficiencies in the planning and performance of these audits at three of the five contractors. As a result, the audit office rescinded five reports on July 11, 2011.

Our Response

The comments from DCAA are responsive. No further action is required on this recommendation.

- d. Any quality assurance review performed on the 54 incurred cost audits identified as performed by the same audit staff and management who performed the FY 2004^{(b) (4)} [REDACTED] incurred cost audit.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The DCAA headquarters quality assurance review explained the review results and recommendations on the adequacy of the quality of work performed as described in this recommendation.

Our Response

The comments from DCAA are responsive. No further action is required on this recommendation.

- e. The Western Region agreed-to training for the Branch Office and the Santa Barbara Suboffice staffs with a verification that the provided training covered the issues identified in this finding in sufficient detail.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA provided a copy of the June 15, 2011, staff conference presentation, Quality Issues in DODIG Review.

Our Response

The comments from DCAA are responsive. DCAA provided training slides, presentation notes, and agendas to document the actions the audit staff should have taken regarding proper actions for the significant deficiencies identified in Finding A. No further action on this recommendation is required.

- f. The Western Region assessment of its audit staff and management involved with Audit Assignment No. 4231-2004P10100013 accurately reflecting the training required, and that the staff and management have either received or are scheduled to receive the required training in FY 2011.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA provided the August 25, 2011, Memorandum for Record signed by the Deputy Regional Director, Western Region, that details the actions taken by the Western Region for this recommendation. DCAA stated that many of the issues in the report reflect the culture and climate that existed DCAA-wide during the timeframe the assignments were performed. DCAA also believes that employees who worked on the specified assignments received significant training aimed at improving the overall audit quality in the audit office as well as agency-wide. In addition, DCAA communicated its expectations to the workforce regarding performing quality audits in accordance with GAGAS. Finally, DCAA Western Region managers counseled the specific auditors and management staff who were still employed by DCAA and performed significant effort on any of the assignments addressed in this report regarding issues identified on the audits. The supervisor who was most involved with the assignments did not receive the training or counseling because he was no longer a DCAA employee.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

Recommendation A.2

We recommend that the Regional Director, Western Region, provide to this office:

- a. Written product documenting his staff's determination of the appropriate actions needed to correct any identified performance deficiencies for the audit staff and management who worked on the FY 2004 (b) (4) incurred cost audit.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA provided an August 25, 2011, memorandum signed by the Deputy Director, Western Region, addressing the actions taken to address the performance of the audit staff who worked on the FY 2004 (b) (4) incurred cost audit. DCAA believes that the counseling provided to the auditor, along with the additional training, guidance, and communication of expectations as previously discussed, is sufficient to address the audit performance concerns identified.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- b. An action plan detailing the identified actions with the estimated completion dates.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA anticipated prioritizing the previously discussed additional audit work during FY 2012.

Our Response

The comments from DCAA are responsive. Additional information is in our response to Recommendation A.1.b. No further action on this recommendation is required.

Recommendation A.3

We recommend that the Branch Manager, Central Coast Branch Office:

- a. Provide to this office, a copy of the memorandum rescinding Audit Report No. 4231-2004P10100013.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA provided a copy of the rescission memorandum issued on January 26, 2011, to the Administrative Contracting Officer.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- b. Perform additional testing on the contractor's claimed FY 2004 and FY 2005 direct costs, addressing the risk factor that the contractor may have charged costs into the wrong account, and provide a written report to this office.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA stated they were in the process of completing fieldwork related to the additional direct cost testing of (b) (4), FY 2004 and FY 2005 incurred cost submissions.

Our Response

The comments from DCAA are responsive. DCAA provided Supplemental Audit Report No. 4231-2004P10100024, (b) (4), 'FY 2004 Incurred Cost Audit,' dated April 24, 2012, and Audit Report No. 4231-2005P10100027, (b) (4), 'FY 2005 Incurred Cost Audit,' dated May 24, 2012. No further action on this recommendation is required.

- c. Provide to this office copies of the written request to (b) (4) to abrogate its signed rate agreements for FYs 2004 through 2006 indirect rates and the contractor's written response.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, partially agreed. On February 8, 2011, DCAA approached (b) (4) regarding its willingness to abrogate its FY 2004 and FY 2005 indirect rate agreements. The contractor, in a February 14, 2011, written response, refused to abrogate the agreements, stating it believed the agreed-to "rates are appropriate" for those years. DCAA disagreed that the review of the contractor's FY 2006 incurred costs was inappropriately performed as a desk review given that the only flexibly-priced contract performed in 2006 was contract HQ0006-05-7230, which the contractor had charged \$ (b) (4) in excess of the cost ceiling of \$ (b) (4).

by year end. Thus, DCAA did not rescind the FY 2006 desk review memorandum nor did it request the contractor to abrogate its FY 2006 rate agreement.

Our Response

The comments from DCAA are responsive. Based on the contractor's refusal to abrogate prior years' agreements, additional effort on the FY 2006 incurred cost audit would be an inefficient use of resources. No further action on this recommendation is required.

- d. Perform additional testing of FYs 2004 through 2006 (b) (4) indirect costs when the contractor agrees to abrogate the negotiated rate agreements for those years.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, disagreed. DCAA stated that (b) (4) refused to abrogate the FY 2004 and FY 2005 indirect rate agreements and DCAA does not believe there is sufficient risk related to the FY 2006 indirect rate agreement to necessitate its abrogation. Therefore, DCAA will not perform additional testing of indirect costs for these years as the associated final indirect rates are binding.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- e. Provide to this office the re-issued Audit Report No. 4231-2004P10100013 that incorporated the identified expressly unallowable cost and the results of additional testing of direct and indirect cost accounts.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA stated they were in the process of completing the additional direct cost testing on (b) (4) 2004 incurred cost submission.

Our Response

The comments from DCAA are responsive. DCAA provided Supplemental Audit Report No. 4231-2004P10100024, "(b) (4) FY 2004 Incurred Cost Audit," dated April 24, 2012. No further action on this recommendation is required.

- f. Place a memorandum in the audit file stating that the audit is not an acceptable example of an incurred cost audit and cannot be used in future audit planning to assess risk at less than maximum for each of the 54 audits performed by the same audit staff and management as performed the FY 2004 ^{(b) (4)} [REDACTED] incurred cost audit for which a quality assurance review is not performed or for which additional testing is not performed.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, partially agreed. Of the 54 assignments identified as being performed by the same audit staff and management, DCAA performed 40 as audits and 14 as desk reviews. Therefore, for the 40 audits, DCAA included a memorandum indicating that:

- subsequent oversight reviews have called into question the sufficiency of the audit;
- the audit should not be used as an acceptable example of an incurred cost audit; and
- the audit cannot be used in future audit planning to assess risk at less than maximum.

DCAA provided a reconciliation of the 54 assignments identifying which were conducted as a desk review and were considered an audit.

Our Response

The comments from DCAA are responsive. No further action is required for this recommendation.

- g. Provide to this office, copies of all memoranda placed in the audit files as required by the Recommendation A.3.f.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, referred to the previous recommendation's response. DCAA provided an example of the subject memorandum for one of the applicable audit assignments.

Our Response

The comments from DCAA are responsive.

Finding B

Paid Voucher Reviews (Allegation 7)

~~(FOUO)~~ We substantiated the allegation that time and material (T&M) contract vouchers were excluded from review under Assignment No. 4231-2005P11015002, (b) (4) FY 2005 Paid Voucher Review. The Suboffice did not comply with DCAA guidance when it excluded T&M vouchers from its paid voucher review. T&M vouchers represented 93 percent (\$^{DCAA: (b) (4)} of \$^{DCAA: (b) (4)}) of the costs subject to audit. Therefore, the Suboffice did not adequately plan or perform this assignment. In addition, the Suboffice Memorandum for Record on the assignment inaccurately described the work performed. The memorandum improperly expressed an opinion on the contractor's billing system, given that DCAA obtained insufficient evidence to provide a reasonable basis to express an opinion. Additionally, DCAA erroneously stated that the examination was conducted in accordance with GAGAS. Because of the deficiencies, the Government had no assurance that the contractor properly calculated the majority of the interim reimbursable vouchers submitted for payment in FYs 2004 and 2005.

Direct Bill Program

DFARS 242.803(b)(i)(C), Disallowing Cost After Incurrence, applicable during the period of review, gave DCAA the authority, as the contract auditor who is the representative of the contracting officer, to authorize contractors that met certain requirements to participate in the direct bill program.⁶ Contractors, generally, had to submit reimbursable vouchers through DCAA to obtain interim payment under cost-reimbursement, T&M and labor hour contracts, and cost reimbursement portions of fixed price contracts. The direct bill program allowed a contractor to submit interim vouchers directly to the appropriate paying office.

Paid Voucher Review

Prior to an August 29, 2012 DFARS revision, DCAA performed a paid voucher review to determine whether a contractor could continue to participate in the direct bill program. DCAA did not perform paid voucher reviews in compliance with GAGAS.

⁶ Effective August 29, 2012, DFARS 242.803(b)(i) was revised to remove DCAA's authority to authorize direct interim voucher submission to the disbursing office. It also specified that interim vouchers would be selected for a pre-payment review prior to provisional approval using sampling methodologies. Implementation of the DFARS revision eliminated the direct bill program.

In particular, the standard DCAA audit program did not require sufficient testing to allow the auditor to give an overall opinion on the contractor's system of internal controls. DCAA guidance instructed its auditors that any written product issued on a paid voucher review should not state that the review was performed in accordance with GAGAS. As part of a paid voucher review, the auditor should have tested a representative selection of paid vouchers that were submitted directly to the Government paying offices. The DCAA standard audit program required the auditor to:

- determine whether the vouchers were mathematically correct and free of errors;
- determine that the vouchers were prepared using current amounts from the accounting records, and that the costs billed were reconciled to the cost booked for the billing period being reviewed;
- verify that the vouchers were prepared using Government-approved provisional billing rates;
- determine billings were based on current contract provisions;
- verify that the vouchers contained current and cumulative billed amounts;
- compare the amounts received to the amounts billed for each voucher and notify the appropriate paying office if any differences were identified;
- verify that the contractor was current on its submission of incurred cost proposals; and
- verify that the contractor submitted final vouchers for physically complete contracts in accordance with the FAR.

Testing of Interim Vouchers

~~(FOUO)~~ The auditor did not test a representative sample of paid vouchers as required by DCAA guidance. For a two year period, the auditor only selected six cost-plus-fixed-fee or cost-plus-award-fee vouchers for review. Two of the six vouchers were inappropriately included because they were for subcontracts which are not included in a paid voucher review. Additionally, T&M vouchers were excluded from this review even though T&M contracts represented 93 percent of the FY 2005 auditable dollars at the contractor. In the risk assessment, the auditor stated that the contractor sends the T&M vouchers to the customer for final approval prior to being submitted to the appropriate paying office. The auditor also noted that the number of T&M contracts

that (b) (4) was awarded from the General Services Administration schedule increased each year and that these T&M vouchers were not part of the direct bill program and, therefore, would not be tested. The auditor did not verify that the contract instructs (b) (4) to submit interim vouchers directly to the contracting officer. DFARS 242.803(b)(i)(B), Disallowing Costs After Incurrence, in effect at the time, assigned DCAA the responsibility to provisionally approve interim vouchers prior to payment. DCAA approval of interim vouchers was required for applicable DOD-funded contracts let by the General Services Administration because FAR 8.404(b)(1) requires the contracting officer to include the regulatory and statutory requirements applicable to the agency for which the order is placed. The auditor did not correctly interpret the guidance provided in the audit program and the DCAA contract audit manual and inappropriately excluded all the T&M vouchers from the review.

Expression of an Opinion

The Suboffice inappropriately closed Assignment No. 4231-2005P11015002 with a Memorandum for Record using the standard report wording for an internal control system review instead of a paid voucher review. Therefore, the memorandum erroneously stated the examination tested the billing system internal control procedures for the 'Management Reviews', 'Policies and Procedures', and 'Implementation of the Policies and Procedures Control Objectives.' It also incorrectly concluded that the examination provided a reasonable basis for the opinion and was conducted in accordance with GAGAS. The auditor, however, did not perform compliance testing of the three control objectives mentioned and the working papers did not contain sufficient evidence to formulate an overall opinion on the contractor's billing systems internal controls. The standard wording for the memorandum for record on the results of a paid voucher review specifically states that it does not constitute an audit or attestation engagement under GAGAS.

DCAA Response to Preliminary Results Memorandum

DCAA provided clarifying information that we used to revise our preliminary findings on this assignment. DCAA generally agreed with the issues identified and the recommendations related to Assignment No. 4231-2005P11015002. DCAA agreed that the Memorandum for Record should not have stated that the assignment was an examination performed in accordance with GAGAS, tested internal control objectives, and provided a reasonable basis for an opinion. DCAA agreed with the recommendations to rescind the Memorandum for Record, place a memorandum in the file stating the

audit work should not be relied upon or used as an example, conduct another paid voucher review covering a representative sample of contracts, and undertake a review of the billing instructions in the (b) (4) T&M contracts.

Recommendations , Management Comments and Our Response

Recommendation B

We recommend that the Branch Manager, Central Coast Branch Office:

1. Provide a copy to this office of the Memorandum for Record rescinding the Memorandum for Record written for Assignment No. 4231-2005P11015002

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA provided a copy of the memorandum issued on January 26, 2011, noting the rescission of the (b) (4) paid voucher review conducted for Assignment No. 4231-2005P11015002.

Our Response

The comments from DCAA are responsive. No further action is required on this recommendation.

2. Provide a copy to this office of the memorandum placed in the assignment file stating that the work should not be relied on or used as an example to perform another paid voucher review.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The January 26, 2011, memorandum discussed in DCAA's response to Recommendation B.1.a also included language that the work should not be relied on or used as an example to perform another paid voucher review.

Our Response

The comments from DCAA are responsive. No further action is required on this recommendation.

3. Conduct another paid voucher review covering a representative sample of contracts to ensure that the contractor is billing only allowable costs by the agreed-to date of September 30, 2011.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA established Assignment No. 4431-2011P11015006 to perform another paid voucher review at (b) (4) Research, Inc.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

4. Provide to this office a copy of the written product and working papers documenting the (b) (4) paid voucher review when completed.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA will provide a copy of the final assignment memorandum and associated working papers upon the completion of the current (b) (4) paid voucher review being performed for Assignment No. 4431-2011P11015006.

Our Response

The comments from DCAA are responsive. This assignment had no findings and DCAA closed it with a Memorandum for Record on May 17, 2013.

5. Provide written documentation to this office showing:
 - a. the (b) (4) T&M contracts identified by the Branch Office that have billing instructions that do not comply with DFARS 242.803;

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The audit office performed an analysis of the billing instructions contained in (b) (4) T&M contracts and determined that the contract billing instructions comply with the criteria in DFARS 242.803.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- b. the written notification to the contracting officer(s) that the contract(s) should be modified to provide for DCAA provisional approval of interim vouchers; and

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, disagreed. The audit office did not identify any noncompliant billing instructions.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- c. copies of the modification to the contract(s) for the revised billing instructions.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, disagreed and stated that the audit office did not identify any noncompliant billing instructions.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

Finding C

Request for Employee Stock Ownership Plan (Allegation 14)

We substantiated the allegation that the supervisor did not support an auditor's request for a list of (b) (4). Employee Stock Ownership Plan (Plan) participants. However, the supervisor was correct not to pursue obtaining the information. The ownership information supplied by (b) (4) was sufficient for updating the company ownership information on the internal control questionnaire during the initial planning process. The Plan is a separate legal entity from (b) (4) and is the shareholder of record;⁷ therefore, the individual Plan participants are not considered (b) (4) shareholders. The auditor's objective to identify potential related party transactions is appropriate once the auditor selects specific direct or indirect cost accounts for review or identifies potential fraud indicators for related party transactions. The auditor had not selected individual accounts or transactions to review because this audit was still in the planning stage. Therefore, the auditor had no basis to request a list of Plan participants from the Plan. Additionally, the auditor could have obtained similar information directly from (b) (4).

⁷ The term "shareholder" is defined under California Corporation Code to mean "the holder of record of shares."

Employee Stock Ownership Plan

For legal reporting of ownership, the Plan is the holder of record, not the individual Plan participants, for all common stock shares held in the Plan. According to (b) (4) Plan participants simply have the right to share in the appreciation or depreciation of the company's value. From May 31, 2005 to May 31, 2007, no single participant had accumulated the rights to more than 2 percent of the total Plan shares. Over 500 current employees participate in the Plan. When a participant has a distributable event, such as retirement or other termination of employment, the participant receives cash equal to the value of any units allocated for bookkeeping purposes to his or her account under the Plan.

(b) (4) Ownership Information

According to the contractor, the President and the Chief Financial Officer together own approximately 12.5 percent of the outstanding company stock. The Plan holds

87.5 percent of the outstanding company stock. The contractor's general manager is the largest Plan participant with less than 1.7 percent of the total released Plan shares.⁸ A (b) (4) representative also told the auditor in an email that neither the President nor the Chief Financial Officer has any related party participating in the Plan.

Audit Planning

The information provided by the contractor met the DCAA requirements for the initial risk assessment and audit planning. During the audit planning stage, the auditor is required to update an internal control questionnaire⁹ which includes questions regarding company ownership. For a non-publically traded or privately held company, the questionnaire requires information such as type of organization, contractor fiscal year, major products and services, breakdown of sales for the most recently completed fiscal year, outside auditors, value of pension assets and liabilities, and names and titles of principal executives. The questionnaire also has a question identifying related party transactions specifically for leased plant or facilities. For FY 2007, (b) (4) provided an excel spreadsheet with the names of the principal executives by position, unallowable costs and voluntary reductions, and compensation amounts for the ten most highly compensated officers and employees. (b) (4) also stated that it had no related party transactions for leased plant or facilities. (b) (4) did not provide the number of shares owned by individual Plan participants as initially requested by the auditor. The auditor subsequently rescinded the request based on guidance provided by the supervisory auditor.

Reason for Plan Information

Without specific leads or fraud indicators on related party transactions, the auditor's primary concern should be whether the Plan costs charged to the Government were properly calculated and allocated. The auditor stated that ownership information was a fundamental piece of information needed to plan audit testing for direct and indirect costs to recognize higher risk-related party transactions or those with a financial interest in the company. The auditor also planned to use the information to identify non-employee participants in the Plan and determine whether the contractor inappropriately claimed costs for non-employees. According to (b) (4) the annual Plan contribution is based on an assessment of the overall financial health of the company and does not directly vary with the number of Plan participants; therefore, how Plan

⁸ This represented less than 1.4 percent of the total company shares.

⁹ The internal control questionnaire is used to document an understanding of internal controls at non-major contractors with auditable dollar volume between \$15 and \$90 million in FY 2007.

costs are distributed to individual Plan participants is generally not within the scope of a DCAA audit. The Internal Revenue Service is responsible for reviewing the Plan to determine whether the Plan participants meet the eligibility qualifications.¹⁰

Identifying Related Party Transactions

Standard audit steps for determining whether inappropriate related party transactions exist generally begin with the identification of a cost that appears to be significant, unusual or unreasonable. The cost is then traced to a transaction or series of transactions and the supporting documents or information is further evaluated. In this case, the proposed audit approach could have been pursued by obtaining a list of all current or former employees or only those who held key positions with the authority to commit or spend money or influence how contractor funds were expended. The auditor could have informally determined which employees had the greatest share in the Plan by identifying higher paid employees such as the officers and long-term employees. Both groups of employees should have a higher percentage of rights in the Plan versus lower paid or short-term employees because of how Employee Stock Ownership Plans function.

Testing Plan Costs

At the time of our review, the audit plan did not include testing indirect costs such as the Plan costs. The Suboffice last tested indirect costs claimed in the FY 2002 incurred cost audit. The in-process working papers for the FY 2007 (b) (4) incurred cost audit did not contain documentation of a formal request to (b) (4) to provide details of the \$ (b) (4) in claimed Plan costs or the calculations used to allocate those costs to the Plan participants. The auditor had sufficient information from the contractor's incurred cost submissions to assess the initial risk associated with claimed Plan costs. However, the working papers did not contain a properly completed indirect cost comparison or a separate analysis or comparison of the Plan costs.¹¹ As required by DCAA guidance, the auditor should have calculated for each indirect cost account, the percentage increase or decrease in its costs from FY 2006 to FY 2007. Also, the contractor's submissions for FYs 2005 through 2009 disclosed continuous increases in Plan costs. For instance, Plan costs increased 21 percent from FY 2004 to

¹⁰ The eligibility of an employee to participate in the Plan is determined by the Plan Administrator and is based on information furnished by the employer.

¹¹ DCAA guidance requires the auditor to compare indirect cost account balances from one year to another to determine where significant increases or decreases in indirect costs have occurred. The purpose of the Mandatory Annual Audit Requirement No. 15, Indirect Cost Comparison with Prior Years, is to identify changes in cost accounting practices, reclassifications of costs, and areas with substantial increases or decreases in cost incurrence that require further audit analysis.

2005. The percentage of increase in Plan costs from one year to the next ranged from a low of 7 percent to a high of 50 percent.

Other indications of a need for further review include: (i) the contractor's submission listed no Plan costs as voluntarily deleted for FYs 2004 or 2005, and (ii) the contractor did not credit or decrease the claimed Plan costs for any interest or dividends. This information should result in the auditor selecting the Plan costs for further review.

(FOUO) Due to the mix of contracts that (b) (4) had in 2007, any questioned indirect costs such as the Plan costs, would result in (b) (4) reimbursing the Government 11.7 percent of any questioned costs¹² sustained by the contracting officer. Additionally, a lower historical general and administrative rate should result in lower future negotiated rates for T&M and labor hour contracts.

Technical Guidance

The Suboffice did not submit a formal request to the Western Region Special Programs Office for technical guidance on the appropriateness of requesting the Plan participant information. However, the supervisor did informally discuss with a regional technical specialist the issue as allowed by Western Region Instruction Number 7640.24, Requesting and Processing Requests for Regional Technical Guidance. Neither the supervisor nor the regional technical specialist supported the auditor's request for additional Plan information because legally, no individual, other than the President and the Chief Financial Officer, is considered a shareholder of record. Because of this lack of direct ownership, the regional technical specialist and the supervisor did not believe that related-party issues would exist with the Plan participants. The regional technical specialist provided the informal guidance verbally to the supervisor. The supervisor did not comply with the Western Region Instruction Number 7640.24 requirement to include the auditor in conference calls or emails relating to an informal guidance request. In an email to the auditor, the supervisor explained the reason for not supporting the auditor's request and that the issue had been discussed with the Branch Office manager and the acting Branch Office manager who concurred with the regional technical specialist's guidance. However, in the same email, the supervisor provided the auditor guidance on when the auditor could request certain additional Plan participant information.

¹² The Government gets reimbursed for any questioned claimed costs that the contracting officer sustains based on the percentage of cost redeterminable contracts that the contractor has for that year. Cost redeterminable contracts include fixed price incentive and all cost type contracts.

In addition, during your transaction testing of individual accounts, if you come across transactions between (b) (4) and a specific individual (as opposed to companies), you can then request confirmation from (b) (4) that the individual is or is not one of the ESOP (Employee Stock Ownership Plan) participants.

Based on the supervisor's instruction, the auditor withdrew the request to (b) (4) for share details of the individual plan participants. Written informal guidance from the regional technical specialist and inclusion of the auditor in verbal discussions and email distributions would have helped ensure that all parties involved fully understood the issue and the regional guidance provided.

DCAA Response to Preliminary Results Memorandum

In response to our findings on incurred cost audits, DCAA agreed to perform a quality assurance review of the FYs 2003, 2004, and 2005 (b) (4) incurred cost audits if the contracting officer had not settled the indirect rates for those years. Western Region will review the FYs 2006 and 2007 incurred cost audits prior to the audit office issuing the reports to ensure that sufficient testing was performed. DCAA partially agreed with the issues identified and two recommendations related to audit guidance provided by the Western Region. The Western Region Technical Programs Division agreed to sample audit specific guidance they had provided to auditors and technical specialists throughout the region to verify that it has been included in the working paper files.

Recommendations, Management Comments, and Our Response

Recommendation C.1

We recommend that the Director, DCAA:

- a. Provide to this office the DCAA Headquarters Quality Assurance report of its review of the FYs 2003, 2004, and 2005 (b) (4) Research, Inc. incurred cost audits.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The DCAA Integrity and Quality Assurance Directorate performed quality assurance reviews on the (b) (4) FY 2003, 2004, and 2005 incurred cost audits and issued the results in its June 30, 2011,

Memorandum Q 225.4. The quality review recommended rescission of all three (b) (4) incurred cost audits. The Central Coast Branch Office issued one rescission memorandum addressing all three reports on July 11, 2011.

Our Response

The comments from DCAA are responsive. No further action is required on this recommendation.

- b. Revise the existing internal control questionnaire to include a question identifying all related parties and any material-related party transaction.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. By December 2011, DCAA planned to revise the internal control questionnaire to include a requirement for the contractor to identify related parties and any material related-party transactions.

Our Response

The comments from DCAA are responsive. DCAA provided a copy of the revised internal control questionnaire, Version No. 2.2 dated March 2012, that included the requirement. No further action is required on this recommendation.

Recommendation C.2

We recommend that the Regional Director, Western Region, provide to this office:

- a. The estimated completion date(s) for the (b) (4) FY 2006 and 2007 incurred cost audits.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA anticipated prioritizing the completion of the 2006 and 2007 (b) (4) incurred cost audits during FY 2012 as the fieldwork associated with these audits was not yet complete.

Our Response

The comments from DCAA are responsive. DCAA issued a report on FY 2006 incurred cost audit on January 7, 2014, and closed the FY 2007 incurred cost audit on January 9, 2014, without a report. DCAA informed us that the contracts affected by

these audits were closed and could not be reopened at this time; therefore, we agreed that spending additional audit resources on the audits would not be appropriate.

- b. The estimated completion date(s) of the Western Region assessment of the (b) (4) FY 2006 and 2007 incurred cost audits.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. As previously noted, DCAA emphasized expectations regarding sufficient testing to support audit opinions. The 2006 and 2007 (b) (4) incurred cost audits remain open with additional fieldwork to be completed. The Western Region planned to perform an assessment of the in-process audit.

Our Response

The comments from DCAA are responsive. DCAA Western Region did not perform an assessment since the 2006 and 2007 incurred cost audits were closed without additional audit work being performed.

- c. A written product detailing the Western Region's assessment of the (b) (4). FY 2006 and 2007 incurred cost audits and its results.

Defense Contract Audit Agency Comments

The Regional Director, Western Region, agreed. As stated in Recommendation C.2.b., DCAA planned to complete its assessment and provide a copy to the DoD IG.

Our Response

The comments from DCAA are responsive. As explained in Recommendation C.2.a and b, DCAA closed the two incurred cost audits due to the expiration of the Statute of Limitations.

- d. A written product documenting the Western Region Technical Programs Division review of the audit-specific guidance provided to field audit staff to verify that the guidance was included in the applicable audit working paper files.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The Western Region Technical Programs Division reviewed selected regional guidance and found that the majority of audits appropriately documented regional guidance; however, improvements were desired. The Regional Technical Programs Division planned to implement process improvements that required documentation of formal and informal audit guidance in the audit working paper file.

Our Response

The comments from DCAA are responsive. DCAA provided documentation of the process improvements. No further action is required on this recommendation.

Finding D

Floor Check Audit (Allegation 6)

We substantiated the allegation that Assignment No. 4231-2007P10310002, (b) (4) 2006 Floor Check Audit, did not support the conclusion that interviewed employees had charged the appropriate contracts. The supervisor did not allow the auditor to add a step to the standard audit program to verify the information or documents provided by employees to the contract requirements. However, nonperformance of this audit step was not the primary reason the work did not support the report conclusion that "...employees were actually at work, performing duties in their assigned job classification, and time was charged to the appropriate job...". The report conclusion was not supported largely due to poor planning and the gathering of insufficient evidence. The audit did not comply with the GAGAS requirements for exercise of professional judgment, planning, execution, supervision, and reporting. Based on the high risk resulting from prior audit results and uncorrected labor accounting deficiencies, a more comprehensive labor audit should have been planned and performed. Interviewing only 13 of 800 employees (1.6 percent) resulted in insufficient evidence being obtained. The auditor inappropriately used budgeted hours rather than the assessed risk to determine the number of employees to interview. DCAA determined that insufficient evidence was also obtained in the 2008 and 2009 floor checks and no floor check was performed in 2007. Therefore, DCAA will need to increase its testing of labor costs for the 2006 through 2009 incurred cost audits.

Floor Check Audit

Annual floor checks are an integral part of the audit coverage of contractor labor costs and help to ensure the accuracy of labor charges. During a floor check, the auditor tests the contractor's compliance with its timekeeping internal controls and procedures to ensure the reliability of employee time-records. The auditor physically observes employees in the assigned work areas to determine whether employees are actually working, performing in the assigned job classification, and charging the appropriate job. According to the DCAA Contract Audit Manual, Chapter 6-404.5, "Inadequate internal controls or noncompliance with those controls greatly increase the risk that labor mischarging could be occurring. The scope of the audit should be adjusted in accordance with the risk determined in the audit of the labor system of internal controls." Additionally, the extent and frequency of floor checks depends on the adequacy and reliability of the contractor's system for controlling time,

internal controls, the frequency and effectiveness of floor checks by contractor personnel, and the reliability of records indicated by previous floor checks. When conditions indicate that a high probability of mischarging exists, the audit office should perform a comprehensive analysis of labor charging and allocation, including employee interviews.

Work Performed During the Floor Check Audit

Planning the Audit

(FOUO) The Suboffice did not adequately plan the audit as required by GAGAS. The Suboffice should have performed a comprehensive labor audit or significantly augmented the standard floor check audit steps. This error in judgment was compounded by the decision to interview only 1.6 percent of the employees. The standard floor check audit program includes a step for the auditor to discuss the nature of the work being performed and to observe the actual work performance to determine whether the employee is performing in the proper direct or indirect labor capacity and whether the time is being charged correctly. The auditor added another step to compare the work observed and described by the employee during the floor check to the terms of the contract. The supervisor advised the auditor to remove the added step since it was not part of the standard audit program and refused to grant the auditor any additional time to perform it. Based on the completed risk assessment and DCAA guidance, the plan to interview only 13 (1.6 percent) out of 800 employees was inappropriate. The completed risk assessment indicated:

- Four (24 percent) out of seventeen employees during the last floor check performed in October 2005 did not record hours timely.
- The contractor did not implement an agreed to corrective action by the promised date of March 31, 2006, regarding the lack of written policy on overhead project documentation. The 2005 floor check report identified the same deficiency.
- The contractor did not have a time keeping policy regarding improvement projects.
- The contractor did not perform internal floor checks on a regular basis.
- In 2005, \$^{DCAA: (b) (4)} of the contractor's \$^{DCAA: (b) (4)} total sales were to the Government. Of the Government sales, \$^{DCAA: (b) (4)} were for flexibly priced contracts.

The identified risk factors indicate that a high probability of mischarging existed. Therefore, the Suboffice should have considered the audit high risk and planned the audit scope accordingly. When conditions indicate a high probability of mischarging exists, the auditor should conduct a comprehensive analysis of labor charging. The auditor also should have considered using statistical sampling for attributes rather than a judgment selection to ensure that enough employees were interviewed to provide sufficient evidence.

Revising the Audit Scope

The Suboffice did not properly adjust the floor check plan and scope based on the audit's initial findings as required by GAGAS and DCAA guidance. The auditor discovered that 5 (38 percent) out of the 13 employees interviewed did not fill out the timesheet in a timely manner. At this time, the Suboffice could have mitigated some of the audit planning deficiencies identified above. Based on the initial results and the previously identified risk factors, the auditor and supervisor should have revised the audit scope and included additional audit steps. This could have included analyzing labor charging patterns, conducting more in-depth interviews, and verifying documents and information provided by employees during the floor check to contract requirements. Performing this step as part of the floor check instead of during a later audit would have been appropriate considering the nature and significance of identified repeat deficiencies.

Floor Check Audit Report

The Suboffice should not have issued Audit Report No. 4231-2007P10310002, Report on Floor check Procedures, dated January 4, 2007, because of the deficiencies in audit planning and execution discussed above. Additionally, the report conclusion that "...employees were actually at work, performing duties in their assigned job classification, and time was charged to the appropriate job..." was not supported by the evidence. We also noted that the Suboffice did not provide the floor check audit results to the DCAA office cognizant of the higher-tier (b) (4) components. The DCAA auditors cognizant of the higher-tier (b) (4) component are also responsible for the auditing of the higher-tier component's labor system. The DCAA audit office needs to be aware of the deficiencies the Suboffice identified in order to properly assess any risk that the deficiencies are component-wide.

DCAA Response to Preliminary Results Memorandum

DCAA agreed with all of the issues identified and with the eight recommendations related to Assignment No. 2007P10310002, (b) (4) 2006 floor check audit. The DCAA response pointed out that the memorandum on attribute sampling [MRD 10-OTS-069(R)] issued on October 20, 2010, included guidance on establishing sample sizes. DCAA will revise the standard audit program and audit report format for labor floor checks to clarify the audit step on verifying work products observed to contract requirements, will rescind Audit Report No. 4321-2007P10310002, notify all report recipients of the rescission, and place a memorandum in the audit file documenting that the assignment did not comply with GAGAS. DCAA also agreed to revise all standard audit report formats and clarify appropriate Contract Audit Manual sections to require distribution of reports or memoranda with the results of audits to higher-tier DCAA audit offices, when appropriate. As a result of our recommendation, DCAA determined that no floor check was performed for 2007 and the floor checks for 2008 and 2009 also covered an insufficient number of employees resulting in the gathering of insufficient evidence. DCAA will also rescind the 2008 and 2009 reports and take other actions associated with report rescission.

Recommendations, Management Comments, and Our Response

Recommendation D.1

We recommend that the Director, DCAA:

- a. Provide written documentation to this office of the additional guidance provided to the field audit offices on performing floor checks and labor interviews, and the guidelines on the number of employees to be interviewed for different audit circumstances.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA noted in its December 22, 2010, response to the APO Preliminary Review Results Memorandum that this action was completed on October 20, 2010. DCAA issued new policy on attribute sampling in the Memorandum for Regional Directors No. 10-OTS-069(R) that included revised policy guidance on establishing sample sizes. DCAA was assessing the need for additional floor check guidance and planned to advise the DoD IG on the results of this assessment.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- b. Provide to this office, a copy of the revised labor floor check standard audit program that includes an audit step to verify the work products observed during interviews be traced to contract requirements.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. At the time of their response, DCAA was in the process of revising the standard audit programs and planned to provide copies to the DoD IG upon completion.

Our Response

The comments from DCAA are responsive. DCAA completed this revision on October 31, 2013 and provided copies to this office. No further action on this recommendation is required.

- c. Provide to this office, by the agreed-to date of June 30, 2011, all revised standard audit report formats and appropriate Contract Audit Manual sections that require distribution of the report or memorandum to higher tier DCAA audit offices, when appropriate.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. At the time of their response, DCAA was in the process of revising the Contract Audit Manual sections that require distribution of the report or memorandum to the higher tier DCAA audit offices.

Our Response

The comments from DCAA are responsive. DCAA completed this revision on October 31, 2013 and provided copies to this office. No further action on this recommendation is required.

- d. Perform quality assurance reviews of the 2006, 2007, 2008, and 2009 (b) (4) incurred cost audits when completed to ensure sufficient testing of labor costs was performed. Provide a copy of the written quality assurance review report to this office when completed.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle. The audits of the 2006-2009 (b) (4) incurred costs had not been started. DCAA planned to ensure the audits were subjected to a pre-issuance Independent Referencing Review following the Agency's existing policy to ensure that the planning and execution of these audits resulted in sufficient testing to support the audit opinion. The (b) (4) 2006-2009 incurred costs are included in the consolidated (b) (4) incurred cost submissions. The 2006-2009 NCS incurred cost audits would be performed by the DCAA (b) (4) North Texas Resident Office.

Our Response

The comments from DCAA are responsive. DCAA issued an audit report on Assignment No. 2811-2006S10100001, "2006 NCS Incurred Cost Audit," on June 26, 2013, and provided working papers to this office showing that increased testing was performed. DCAA issued a report on Assignment No. 2811-2007S10100001, "2007 NCS Incurred Cost Audit," on May 16, 2014. Information in the DCAA management information system indicates that DCAA will complete Assignment No. 2811-2008C10100101, "The 2008 Incurred Cost Audit," by September 30, 2014, and 2811-2009C10100101, "The 2009 Incurred Cost Audit," by March 31, 2015.

- e. Perform a quality assurance review of the Central Coast Branch Office comprehensive labor audit of (b) (4) when completed. Provide a copy of the written quality assurance review report to this office when completed.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle. DCAA was performing a comprehensive labor audit at (b) (4), including procedures performed at the (b) (4) site as (b) (4) does not maintain its own labor accounting system. DCAA planned to subject the audit to a pre-issuance Independent Referencing Review to ensure that the planning and executing resulted in sufficient testing to support the audit opinion.

Our Response

The comments from DCAA are responsive. DCAA issued Memoranda for Record dated November 20, 2013, to close-out Assignment No. (b) (4)

(b) (4) Comprehensive Labor Audit,” on the results of floor checks performed at three NCS locations. DCAA did not identify significant deficiencies at any of the locations.

Recommendation D.2

We recommend that the Regional Director, Northeastern Region:

- a. Provide written documentation to this office verifying that the (b) (4) (b) (4) Texas, increased labor testing in the 2006, 2007, 2008, and 2009 (b) (4) incurred cost audits to take into account the deficiencies in and the results of the (b) (4) labor floor checks for those years.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principal. As noted in its comments to D.1.d the audits of the 2006-2009 (b) (4) incurred costs had not been started as the costs were included in the consolidated (b) (4) incurred cost submissions. The 2006-2009 NCS incurred cost audits were to be performed by the DCAA (b) (4) North Texas Resident Office. On January 26, 2011, the Central Coast Branch Office provided a memorandum to the Resident Auditor of the (b) (4) North Texas Resident Office. The Memorandum instructed DCAA to perform increased labor testing as part of the 2006-2009 NCS incurred cost audits because there was insufficient testing in the rescinded floor check audits conducted by the Central Coast Branch Office.

Our Response

The comments from DCAA are responsive. No further comments are required.

- b. Provide written documentation to this office verifying that the (b) (4) (b) (4) Texas appropriately considered the deficiencies identified by the (b) (4) labor floor checks when planning related (b) (4) audits.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle and referenced its response to Recommendation D.2.a.

Our Response

The comments from DCAA are responsive. No further comments are required.

Recommendation D.3

We recommend that the Regional Director, Northeastern Region:

- a. Provide a copy of the memoranda rescinding Audit Report Nos. 4231-2007P10310002, 4231-2008P1030020, and 4231-200910310010 to this office.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. On January 26, 2011, the audit office notified both the contracting officer and the DCAA (b) (4) North Texas Resident Office that it had rescinded Audit Report Nos. 4231-2007P10310002, 4231-2008P10310020, and 4231-2009P10310010.

Our Response

The comments from DCAA are responsive. DCAA provided the Notice of Rescission dated January 26, 2011. No further action on this recommendation is required.

- b. Provide a copy of the notification memoranda sent to all recipients of the previously listed audit reports informing them that the reports have been rescinded to this office.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed and referenced its response to Recommendation D.3.a.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- c. Provide to this office a copy of the memoranda inserted in the three audit files listed above documenting that the assignments did not comply with GAGAS and should not be used as examples when conducting a floor check audit.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA included a Memorandum for Record dated January 26, 2011, in the working papers files for Assignment Nos. 4231-2007P10310002, 4231-2008P10310020, and 4231-2009P10310010, stating the audits did not comply with GAGAS and should not be used as examples when conducting a floor check.

Our Response

The comments from DCAA are responsive. DCAA provided the Memorandum for Record dated January 26, 2011. No further action on this recommendation is required.

- d. Provide written documentation to this office verifying the Branch Office performed the agreed-to increased labor testing in the (b) (4) 2006, 2007, 2008, and 2009 incurred cost audits.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed and referenced its response to Recommendation D.2.a.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- e. Perform a comprehensive labor audit at (b) (4) as soon as possible, and provide the report to this office.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA was performing a comprehensive labor audit at (b) (4), including procedures performed at the (b) (4) site.

Our Response

The comments from DCAA are responsive. DCAA completed a standard labor floor check at three (b) (4) sites and found no significant deficiencies. DCAA issued a memorandum for record to each site on November 20, 2013 and provided copies to this office. No further comments are required.

Finding E

Request for Regional Guidance (Allegation 2)

We partially substantiated the allegation that the DCAA Western Region Technical Programs Division¹³ (Technical Programs) was not fully responsive to a request from the Branch Office for audit guidance. The allegation is partially substantiated because the technical guidance provided to the Branch Office addressed the issue raised by the auditor even though Technical Programs provided the requested technical guidance 11 months after the original request. The delay resulted from (i) the Branch Office originally submitting an incomplete request; (ii) Technical Programs requesting additional information over several months; (iii) Technical Programs unnecessarily requesting a Headquarters legal opinion; and (iv) Technical Programs being assigned higher priority work. During this time, Technical Programs did not provide status updates to the auditor who had initiated the request. Western Region procedures for requesting guidance from Technical Programs does not encourage a direct exchange of information or advice between Technical Programs staff and the auditor. Improved communications between Technical Programs staff and the field audit staff could result in the field audit staff receiving needed technical advice that is more complete and timely and, thereby, reducing the time taken to issue certain audit reports.

¹³ The Technical Programs Division reports to the Regional Special Programs Manager in the Special Programs Office.

Summary of Events

The Branch Office requested technical guidance from Technical Programs to provide additional information to the administrative contracting officer for inclusion in a response to letters from the contractor's attorneys regarding questioned costs. The Suboffice had issued an incurred cost audit report on October 30, 2007, that questioned \$DCAA: (b) (4) of profit on subcontractor costs.¹⁴ The Branch Office manager's March 27, 2008 draft request for technical guidance on unallowable profit being applied to subcontractor costs lacked some required information and did not comply with Western Region Instruction Number 7640.24, Requesting and Processing Requests for Regional Technical Guidance. Specifically, the request did not contain a sufficient description of the guidance requested, background information, and relevant documentation from the contractor.

¹⁴ Audit Report No. 4231-2005P10100004, Audit of (b) (4) 2005 Incurred Cost.

The Branch Office manager's April 29, 2008 final request for guidance was compliant with the Western Region instruction. However, in September 2008, the Branch Office realized that the request omitted a key provision of Blanket Purchase Agreement F04701-00-A. This omission delayed the Technical Programs' issuance of technical guidance by at least two months. From April 29, 2008 through September 19, 2008, Technical Programs requested and received additional information from the Branch Office. Based on information supplied by the Branch Office, Technical Programs requested a Headquarters legal review on September 19, 2008 with a requested response date of November 19, 2008. The Branch Office informed Technical Programs of its omission of a key provision of the blanket purchase agreement on September 23, 2008. This omission affected the results of the previous research causing Technical Programs to request additional information from the Branch Office from October 31, 2008 through November 19, 2008. Based on the additional information provided, Technical Programs determined that a legal opinion from DCAA Headquarters was no longer necessary.

On March 20, 2009, four months after receipt of the additional information, Technical Programs issued Western Region guidance memorandum RST-4 730.4 to the Branch Office. It contained the following information:

As a prime, team leader, or upper-tier subcontractor, (b) (4) is limited for reimbursement purposes to the amount the lower-tier subcontractor charged in accordance with FAR 52.232-7(b)(4). (b) (4) is not allowed to effectively add a "profit element" to either a team member (those with a GSA Federal Supply Schedule (FSS) rate schedule) or subcontractor (those without a GSA FSS rate schedule). The contractor is only allowed to bill the actual costs of the team member or lower-tier subcontractor.

The guidance provided supported the original audit report opinion on the questioned profit on subcontractor costs even though the report referenced different FAR clauses to support its opinion.¹⁵ Its content, however, does not support a delay of an additional four months. When asked, Technical Programs manager explained that his office was involved in responding to a high profile GAO report issued in July 2008¹⁶ that identified audit and work environment deficiencies in three Western

¹⁵ The report referenced FAR 16.601, Time and Material Contracts, and FAR 31.201-3, Determining Reasonableness.

¹⁶ GAO Report No. GAO-08-857, "DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated," July 22, 2008.

Region locations. The nature of the findings and recommendations caused the Western Region to re-direct some of its resources to deal with the report, which disrupted Western Region operations.

Western Region Instruction Requirements

Western Region Instruction Number 7640.24 requires Technical Programs to issue its guidance on a timely basis. Technical Programs failed to comply with this requirement by issuing its technical guidance nearly one year after the acceptance of the formal request for guidance. The instruction also does not permit the field audit staff to communicate directly with Technical Programs, including formally requesting technical guidance. Instead, the audit office manager must authorize a written request for regional technical guidance; the regional audit manager must coordinate and approve the written request; and then the regional audit manager provides the written request to the Regional Special Programs Manager. Technical Programs also does not provide status updates directly to the field audit staff. The instruction requires the Regional Special Programs Manager to keep regional management, the audit office manager, and the regional audit manager informed of significant developments and the status of those activities. The process established by the instruction does not facilitate communications between the field audit staff who need the requested information to properly perform their audits and the Technical Programs staff who are providing the information. Instead, it sets up a barrier to the exchange of information which could hinder efforts to improve audit quality and provide timely responses. This procedure resulted in Technical Programs and the Branch Office doing a poor job of communicating to the auditor the status of the request.

DCAA Response to Preliminary Results Memorandum

DCAA provided us clarifying information used to revise the preliminary finding. DCAA did not agree that Western Region Instruction Number 7640.24 needed to be revised to require that all the parties involved, including the auditor, be provided status updates on requests so that the Branch Office can make timely and informed decisions about their assignments. However, the Western Region Special Programs Manager will emphasize to his staff the importance of working up front with audit offices to facilitate receipt of complete requests for regional guidance in compliance with Western Region Instruction Number 7640.24. DCAA also agreed to emphasize to audit office managers the importance of keeping audit teams informed on communications with the regional offices on their guidance requests.

Recommendations, Management Comments, and Our Response

Recommendation E

We recommend that the Regional Director, Western Region:

1. Revise the Western Region Instruction Number 7640.24, Requesting and Processing Requests for Regional Technical Guidance, dated September 18, 2009:
 - a. To allow field audit staff, including the auditor, audit office technical specialist, and supervisory auditor to request formal and informal technical guidance directly from the Special Programs Office without management approval;

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, disagreed. DCAA stated that audit staff should seek primary guidance through their chain of command; supplemented by field technical specialists as an additional resource. Current processes established for obtaining guidance help to facilitate adequately managed and supervised audits. Safeguards are in place to address those situations where there are disagreements between the auditors and their management on significant audit issues, which could include situations where disagreements exist on whether to obtain formal technical guidance.

Our Response

Although the Deputy Director, DCAA, disagreed with the recommendation, the action taken for Recommendation E.1.c to emphasize the importance of keeping audit teams informed about their guidance requests satisfied the intent of the recommendation. No further action on this recommendation is required.

- b. to receive the requested guidance directly from the Special Programs Office; and

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, disagreed and referenced the response to Recommendation E.1.a.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- c. to be provided status updates on the submitted requests.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle. Western Region Instruction 7640.24, 6.f(2), dated September 18, 2009, states that the regional special programs manager is responsible for keeping regional management, the audit office manager, and regional audit manager informed of significant developments and status of activities, reflects the expectation that the regional special programs manager would keep the local audit staff apprised of significant developments as it relates to request for audit guidance. DCAA agreed to emphasize to audit office managers the importance of keeping their audit teams informed of communications with the regional office on their guidance request.

Our Response

The comments from DCAA are responsive. DCAA provided a copy of the communication sent to the audit staff. No further action on this recommendation is required.

Recommendation E.2

We recommend that DCAA provide to us written documentation of:

- a. the actions taken by the Western Region Special Programs Manager to emphasize to the regional technical specialists the importance of working up front with audit offices to facilitate receipt of complete requests for regional guidance, and

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The Western Region planned to re-emphasize to the regional technical specialists the importance of working up front with the audit offices to facilitate the receipt of complete requests for guidance and provide a record of that discussion.

Our Response

The comments from DCAA are responsive. DCAA provided a record of discussion with the regional technical specialists. No further action on this recommendation is required.

- b. the actions taken by the Western Region management to emphasize to its managers the importance of keeping their audit teams informed on communications with the regional office on their guidance requests.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The Western Region management planned to re-emphasize to the audit office managers the importance of keeping their audit staff informed of communications with the regional office on their guidance requests and provide a record of that discussion.

Our Response

The comments from DCAA are responsive. DCAA provided a copy of the communication sent to the Western Region audit office managers. No further action on this recommendation is required.

Finding F

Assist Audit of (b) (4) 2004 Incurred Cost (Allegation 5)

Of the three parts to the allegations, we substantiated one part, did not substantiate the second part and partially substantiated the third part. The allegation that the Suboffice:

- Started the (b) (4) 2004 Incurred Cost audit¹⁷ with an inadequate incurred cost submission was substantiated
- Issued Audit Report No. 4231-2004P10100019, with an inadequate incurred cost submission was not substantiated.
- Did not report unallowable costs that (b) (4) had included in the intermediate pool costs¹⁸ was partially substantiated.

The Suboffice started the (b) (4) 2004 incurred cost audit as an assist audit¹⁹ for the DCAA (b) (4) Resident Office in (b) (4) Texas, with both audit offices having an inadequate submission. An inadequate submission can result in a poorly planned audit; therefore, both audit offices should have not started the audit until (b) (4) had submitted a revised submission that was adequate. The portion of the allegation that the incurred cost audit report was issued with an inadequate submission was not substantiated because both audit offices had an adequate submission prior to the issuance of their respective audit reports.²⁰ The portion of the allegation that the Suboffice did not report unallowable costs was partially substantiated because the Suboffice did not perform sufficient testing on direct and indirect costs. (b) (4) removed the unallowable costs previously identified by DCAA and some additional unallowable costs from its revised submission. However, the audit work performed by the Suboffice did not support the overall report opinion on the allowability of the claimed direct and indirect costs for reimbursement purposes. The Suboffice failed to exercise good professional judgment as exhibited

¹⁷ (b) (4) facilities are located in (b) (4).

¹⁸ An intermediate pool is used to accumulate and distribute indirect costs to other pools or cost objectives.

¹⁹ An assist audit is requested by one DCAA audit office of another DCAA audit office that is cognizant of a portion of costs or business system that another location, either a contractor division, subcontractor, or vendor, is responsible for.

²⁰ The (b) (4) issued Audit Report No. 3561-2004S10100001; dated March 6, 2008, on the 2004 (b) (4) incurred cost submission.

in insufficient testing, unacceptable documentation, and ineffective supervision. Additionally, a preliminary review of the 2004 (b) (4) incurred cost audit also identified issues with the amount of evidence obtained. Therefore, due to poor audit work, the Government could have inappropriately reimbursed (b) (4) for unallowable costs

Incurred Cost Submission

FAR 42.705-1,²¹ Contracting Officer Determination Procedure, requires contractors to submit to the contracting officer and DCAA an adequate final incurred cost proposal²² with supporting data within 6 months after the end of the contractor's fiscal year. It refers to the DCAA Model Incurred Cost Proposal in Chapter 6 of the DCAA Information for Contractors Pamphlet (DCAAP 7641.9) as providing guidance on what constitutes an adequate incurred cost submission. The model of an adequate submission includes 16 schedules, which individual contractors may not need or may have to adapt depending on its size, complexity of the accounting system, and type of business. Examples of required information include a summary of claimed indirect expense rates, general and administrative expenses, overhead expenses, claimed allocation bases, schedule of direct costs by contract, and summary of hours and amounts on T&M and labor hour contracts. To be adequate, the contractor's submission must include a signed "Certificate of Indirect Costs" in which a contractor executive certifies that he has reviewed the submission, all costs claimed are allowable in accordance with FAR, and the submission does not include any expressly unallowable costs. DCAA is responsible for determining whether the contractor's incurred cost submission is adequate. DCAA guidance requires that when the submission is inadequate, the auditor should pursue the appropriate course of action, which may include requesting additional information from the contractor or returning the submission as inadequate. When a contractor fails to provide an adequate incurred cost submission, DCAA can recommend that the contracting officer unilaterally settle the indirect rates.

Starting the Audit

The DCAA (b) (4) Resident Office cognizant of (b) (4) requested the Suboffice perform an assist audit of the (b) (4)

²¹ The Allowable Cost and Payment clause at FAR 52.216 also discusses the submission requirement.

²² A final incurred cost proposal can also be called an incurred cost submission.

²³ Effective January 1, 2004, (b) (4) became a business reporting unit of the new (b) (4) segment headquartered in (b) (4) Texas. (b) (4) had sales of \$ (b) (4) DCAA: (b) (4) in 2004.

incurred costs. Both audit offices recognized that the (b) (4) submission was inadequate, but inappropriately started the audits anyway, deciding to work with the contractor to obtain the needed information instead of returning the submission. The (b) (4) Resident Office was responsible for ensuring that the contractor's incurred cost submission was adequate since that office was cognizant of higher tier contractor component (b) (4). On May 4, 2006, the (b) (4) Resident Office issued a letter informing (b) (4) that the submission was inadequate and citing 12 schedules that were either missing or not readily available. The schedules list included:

- occupancy and other service center expenses,
- claimed allocation bases,
- facilities capital cost of money,
- reconciliation of books of accounts and claimed direct costs,
- government participation in the general and administrative expense pool,
- subcontract information, and
- summary of hours and amounts on time and material/labor hour contracts.

The (b) (4) Resident Office also notified the contractor of the Suboffice's concern that (b) (4)' accounting system included errors and omissions that would cause a submission to be inadequate. The (b) (4) Resident Office should have returned the submission to the contractor because the missing information was significant to planning and performing an adequate audit.

Issuing the Audit Report

Both the Suboffice and the (b) (4) Resident Office issued their respective audit reports after receipt of an adequate revised incurred cost submission from (b) (4). The Suboffice issued its audit report on August 30, 2007. On March 6, 2008, the (b) (4) Resident Office issued its report containing a statement that the incurred cost submission was adequate after working with the contractor and including the signed certificate of indirect costs from the original submission. Using the certificate from the original submission did not affect the adequacy of the revised submission because a new certificate is not required when the contractor agrees to lower indirect rates as a result of a DCAA audit of a previously certified proposal.

Intermediate Cost Pools

The original inadequate submission did not clearly detail the claimed intermediate pool costs. The Suboffice resolved the issue of claimed unallowable intermediate pool costs prior to report issuance. When interviewed, the auditor provided a write-up that explained, "The issue of unallowable costs in the intermediate costs pools was addressed in July 2006 by (b) (4) as they removed the \$ (b) (4) identified by the [original] auditor, plus an additional \$ (b) (4) not identified by the original auditor. Ultimately, the contractor included a schedule of the unallowables identified and subsequently updated effected pools and primary pool rate computation. The issue was not dropped, it was resolved." We confirmed that the schedule of unallowable costs was included in the revised submission. The auditor also tested the intermediate pool allocations during the transaction testing done on indirect costs such as utilities, real estate rentals and leases, depreciation, miscellaneous outside services, maintenance, and voluntary deletions. The auditor did not identify any claimed unallowable costs, so none were reported. However, see comments below regarding deficiencies identified in the audit work, including inadequate testing.

Review of Assist Audit Assignment

Overall Audit Quality

The audit work performed did not support the overall report opinion on the allowability of claimed direct and indirect costs for reimbursement purposes. Therefore, the Suboffice demonstrated a lack of professional judgment in performing this assist audit. Insufficient testing and unacceptable documentation indicated that supervision was, at a minimum, ineffective. The audit did not comply with GAGAS and because the audit work was flawed, the Government could have inappropriately reimbursed the contractor.

Audit of Direct Costs

(FOUO) The Suboffice performed very limited testing of 2004 incurred direct costs (labor, materials, and other direct costs) even though direct costs accounted for (b) (4) percent of the dollars to be reviewed (\$ (b) (4)). The Suboffice improperly documented and relied on the testing of \$ (b) (4) of direct materials that the auditor did not actually perform. Also, the Suboffice did not perform sufficient testing of \$ (b) (4) of direct labor costs and did not test other direct costs because they considered the costs to be immaterial.

The audit file contained erroneous documentation that direct material costs were tested when the testing had been planned, but not actually done. The auditor copied the working paper from another assignment, but did not finish revising it for the 2004 incurred cost audit. It is unclear who inappropriately finished the working paper, but the supervisor signed off on it. No testing of materials was ever performed on this audit. For direct labor costs, the auditor did not test any direct labor transactions. Instead, he inappropriately relied on testing done during the 2003 and 2004 floor checks that were insufficient.

Audit of Indirect Costs

The indirect cost testing documentation did not meet GAGAS documentation requirements. The auditor documented the journal entries and the associated amounts selected for review, but did not adequately describe details of the transactions tested. Therefore, an independent reviewer could not determine from the working papers whether there was adequate evidence to determine whether the costs were allocable, allowable, or reasonable. Additionally, the auditor did not list the criteria used to determine whether the transactions were acceptable. During our interview, the auditor provided copies of the supporting documents for some of tested transactions from his personal files. By reviewing those documents (invoices, journal entries, and purchase orders) we were able to determine that the auditor had performed the testing summarized in the working papers and made the proper determination on the allowability of the costs.

Assignment of Audit Staff

The first auditor charged 120 hours to assess the adequacy of the submission and coordinate with the (b) (4) Resident Office. The original auditor was rotated out of the (b) (4) Suboffice in November 2006. The second auditor held the entrance conference on November 15, 2006 and charged 545 hours to complete the assignment. The audit report was issued on August 30, 2007 and the first auditor was not listed in the report. The first auditor later provided us various documents that he believed should have been in the audit file. We identified other audits during this review involving a change in audit staff or a misunderstanding as to who would perform the audit. To address this issue, additional work will be performed and reported on under Project No. D2009-DIPOAC-0107.005.

(b) (4)

Audit

In addition to starting the audit with an inadequate submission, previously discussed above, a cursory review of (b) (4) Resident Office 2004 incurred cost audit of (b) (4) disclosed a lack of audit quality in the following areas:

- incomplete risk assessment performed,
- no cumulative allowable cost worksheet included,
- minimal testing conducted, and
- poor documentation.

Therefore, the (b) (4) Resident Office audit of the (b) (4) 2004 incurred cost submission may not have gathered sufficient evidence to support the acceptance of the claimed indirect costs.

DCAA Response to Preliminary Results Memorandum

DCAA generally agreed with the issues identified and 11 recommendations related to Assignment Nos. 04231-2004P101000019, Assist Audit of (b) (4) (b) (4) 2004 Incurred Cost, and 03561-2004S10100001, Audit of 2004 Incurred Cost for (b) (4). DCAA agreed in principle with evaluating the performance of the audit staff and management who performed the (b) (4) (b) (4) 2004 incurred cost audit and providing them appropriate training, but noted that the majority of the audit team are no longer employed by DCAA. DCAA also pointed out that in 2003, (b) (4) was called (b) (4) and was a part of the (b) (4).

The 2003 incurred cost audit for this (b) (4) business unit is still in process.

Recommendations, Management Comments, and Our Response

Recommendation F.1

We recommend that the Director, DCAA:

- a. Review the completed 2003 (b) (4) [redacted] incurred cost audit to verify that sufficient testing was performed to support the audit report conclusions and opinions. Provide to this office a written product documenting the review and its results.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle. The 2003 (b) (4) [redacted] incurred cost audit had not been completed. This audit included the costs of the 2003 (b) (4) [redacted] incurred costs and was under the responsibility of the Golden State Branch Office, located in El Segundo, California. DCAA planned to perform a pre-issuance Independent Referencing Review on this audit.

Our Response

The comments from DCAA are responsive. DCAA provided Audit Report No. 9861-2003R10100002, "Independent Audit of (b) (4) [redacted]," dated April 30, 2013. No further comments are required.

- b. Review the completed 2004 (b) (4) [redacted] incurred cost audit to verify that sufficient testing was performed to support the audit report conclusions and opinions. Provide to this office a written product documenting the review and its results.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle. DCAA agreed to perform additional testing of direct material costs and direct labor costs prior to issuing a supplemental report on the 2004 (b) (4) [redacted] incurred cost. DCAA planned to perform a pre-issuance Independent Referencing Review on this audit.

Our Response

The comments from DCAA are responsive. DCAA provided Supplemental Audit Report No. 2811-2004P10100019-S1, "Independent Audit of (b) (4), (b) (4), (b) (4), (b) (4) Incurred Cost Proposal for Calendar Year 2004," dated May 21, 2012.

- c. Provide written documentation to this office of the agreed-to assessment of the 2005 (b) (4) incurred cost audit to determine whether additional testing is needed.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. In DCAA Memorandum Q 225.4, dated June 30, 2011, the Integrity and Quality Assurance Directorate recommended rescission of the 2005 (b) (4) incurred cost audit. On August 5, 2011, the Central Coast Branch Office issued a rescission memorandum to the original report recipients.

Our Response

The comments from DCAA are responsive. DCAA provided a copy of the DCAA Memorandum Q 225.4 and Rescission Memorandum dated August 5, 2011. No further action on this recommendation is required.

- d. Provide written documentation to this office of the agreed-to assessment of the (b) (4) Texas audit of (b) (4) 2004 incurred cost audit to determine whether the audit complied with government auditing standards, in particular, to ensure that sufficient testing was performed to support the audit opinion.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The DCAA Integrity and Quality Assurance Directorate issued DCAA Memorandum Q 225.4, dated June 30, 2011, confirming that there was insufficient testing of direct and indirect labor costs, direct materials, and other direct costs.

Our Response

The comments from DCAA are responsive as explained in our response to Recommendation F.1.b. No further action on this recommendation is required.

- e. Provide written documentation to this office of the Western Region agreed-to training to the Branch Office and the Santa Barbara Suboffice staffs and verification that the provided training covered the appropriate issues in sufficient detail.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. On June 15, 2011, all Central Coast Branch Office staff received training on the specific audit quality issues identified by the DoDIG.

Our Response

The comments from DCAA are responsive. DCAA provided a copy of the training materials. No further action on this recommendation is required.

- f. Provide written documentation to this office of the Western Region assessment of audit staff and management involved with Audit Assignment No. 4231-2004P10100019 accurately reflected the training required and that the staff and management have either received or are scheduled to receive the required training in FY 2011.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA stated that all Central Coast Branch Office employees received significant training aimed at improving the overall audit quality within the audit office as well as across the Agency. DCAA also clearly communicated its expectations to the workforce in regards to performing quality audits in accordance with GAGAS. In response to Recommendation A.1.e, DCAA provided a list of specific training received by the Central Coast Branch Office staff aimed at increasing audit quality. The specific auditors and management staff who were still employed by DCAA and performed significant effort on this assignment had been specifically counseled in relation to those audits.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- g. Provide written documentation to this office of the Northeastern Region assessment of audit staff and management involved with Audit Assignment No. 3561-2004S10100001 accurately reflected the training required and that the staff and management have either received or are scheduled to receive the required training in FY 2011.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA planned to review the performance of the management and staff involved in 3561-2004S10100001 and take appropriate actions to correct identified deficiencies. In addition, training would be provided to the audit office on the specific quality issues identified in the assignments reviewed.

Our Response

The comments from DCAA are responsive. DCAA provided documentation of the training to this office. No further action on this recommendation is required.

- h. Provide written documentation to this office of the Northeastern Region agreed-to training to the (b) (4), Texas, verifying that the provided training covered the appropriate issues in sufficient detail.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA referenced its response to Recommendation F.1.g. DCAA will provide the applicable documentation upon completion.

Our Response

The comments from DCAA are responsive. No further comments are required.

Recommendation F.2

We recommend that the Branch Manager, Central Coast Branch Office, Western Region:

- a. Provide a copy of the notification to the contracting officer and the (b) (4) Texas that additional testing must be done on the 2004 (b) (4) incurred cost audit and that additional work may be required for the 2005 incurred cost audit.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. On January 24, 2011, the Central Coast Branch Office notified the (b) (4) Resident Office that additional testing must be completed on the 2004 (b) (4) portion of the (b) (4) incurred cost audit. DCAA noted in Memorandum Q 225.4, dated June 30, 2011, that additional work may be required for the 2005 incurred cost audit as well. As the 2004 and 2005 (b) (4) incurred cost audits were still in process, contracting officer notification was not necessary at the time as the contracting officer was not on distribution list of the 2004 and 2005 (b) (4) audit reports. These reports were only issued to the DCAA (b) (4) Resident Office.

Our Response

The comments from DCAA are responsive. No further comments are required.

- b. Perform the originally planned testing of direct material costs, any additional testing of materials identified by the headquarters review, and additional testing of direct labor costs under Assignment No. 4231-2004P10100019, issue a supplemental report by the agreed-to date of June 30, 2011, and provide a copy of the report to this office.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA agreed to perform additional testing of direct material costs and direct labor costs prior to issuing a supplemental report on the 2004 (b) (4) incurred costs.

Our Response

The comments from DCAA are responsive. DCAA provided a copy of the May 21, 2012, report as explained in our response to Recommendation F.1.b. No further action on this recommendation is required.

- c. Perform any additional testing identified during Headquarters review of the 2005 (b) (4) incurred cost audit and issue a supplemental audit report, if needed, by the agreed-to date of December 31, 2011, and provide a copy of the report to this office.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The DCAA Integrity and Quality Assurance Directorate performed an assessment of the 2005 (b) (4) portion of the (b) (4) incurred cost audit, reference DCAA Memorandum Q 225.4, dated June 30, 2011, and determined that additional testing was required.

Our Response

The comments from DCAA are responsive. DCAA issued Supplemental Audit Report No. 2811-2005P10100020-S1, "Independent Audit of (b) (4) Incurred Cost Proposal for Fiscal Year 2005," on June 4, 2013. No further action on this recommendation is required.

Recommendation F.3

We recommend that the Resident Auditor, (b) (4) Resident Office, Northeastern Region:

- a. Provide a copy of the notification to the contracting officer and other audit offices involved that additional testing had to be done on the 2004 (b) (4) incurred cost audit and that additional work may be required for the 2005 (b) (4) incurred cost audit.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, disagreed because the 2004 and 2005 (b) (4) incurred cost claims were still under audit. As such, notifications were not required.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- b. Perform any additional testing identified during the Headquarters review of the 2004 (b) (4) incurred cost audit, issue a supplemental report by the agreed-to date of December 31, 2011, and provide a copy of the report to this office.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle. The DCAA Integrity and Quality Assurance Directorate performed a post quality review of the 2004 and 2005 (b) (4) portion of the (b) (4) incurred cost claim. The (b) (4) ' 2004 and 2005 incurred cost audits were still in process; therefore, a supplemental report was not required. The Central Coast Branch Office is performing additional testing and will supplement their audit report prior to the issuance of the 2004 and 2005 (b) (4) audits.

Our Response

The comments from DCAA are responsive. DCAA issued supplemental audit reports as explained in our response to Recommendation F.1.b. and F.2.c. No further action on this recommendation is required.

- c. Incorporate the results of any supplemental report issued by the Central Coast Branch Office on the 2004 and 2005 (b) (4) incurred cost audits, issue supplemental reports by the agreed-to date of December 31, 2011, and provide a copy of the report to this office.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle. The 2004 and 2005 (b) (4) incurred cost audits were still in process, as such, no supplemental report was required. The final reports would incorporate the additional testing performed by the Central Coast Branch Office on the (b) (4) portions of those claims.

Our Response

The comments from DCAA are responsive. DCAA issued supplemental audit reports as explained in our response to Recommendation F.1.b. and F.2.c.. No further action on this recommendation is required.

Finding G

Postaward Audit Selection (Allegation 13)

We partially substantiated the allegation that the Suboffice was not selecting (b) (4) contract pricing actions for postaward audits as required by DCAA planning guidance and the same Suboffice personnel generally implemented the defective pricing²⁴ program. The allegation was partially substantiated because since FY 2007, an auditor at the Branch Office, not the Suboffice, was responsible for the defective pricing program which included selecting the (b) (4) pricing actions for postaward review. However, for (b) (4), the Branch Office did not properly implement the DCAA planning guidance on establishing and maintaining the required defective pricing universes; assessing and assigning the appropriate contractor risk rating; and applying the selection criteria. The implementation deficiencies resulted in the Branch Office reducing the number of scheduled postaward audits for the whole office by 82 percent in FY 2008. The Branch Office also canceled all four (b) (4) pricing actions it scheduled for review in FY 2006 through FY 2010; therefore, the Branch Office did not provide the minimum level of coverage - 3 postaward audits within 3 years, that DCAA guidance requires for a contractor with a low risk determination and no firm-fixed-price contracts over \$100 million.

²⁴ Postaward audits are also called defective pricing reviews.

The review of this allegation also identified additional concerns related to the DCAA-wide postaward audit program. DCAA is not completing a sufficient number of defective pricing audits to provide adequate coverage. Overall, DCAA postaward audit coverage has steadily decreased to an unacceptable level. In FY 2008, DCAA completed just 26 percent of scheduled defective pricing audits, an already unacceptable percentage. However, in FY 2010, DCAA completed a mere 5 percent of scheduled defective pricing audits. DCAA also needs to re-evaluate its annual planning guidance to ensure that its implementation provides adequate agency-wide coverage of contractor compliance with the Truth in Negotiations Act. From FY 2008 through FY 2010, each hour charged to a defective pricing audit yielded on average \$2,531 in DCAA recommended price adjustments. Therefore, as a result of the inadequate audit coverage, the Government could have failed to recoup a significant amount of dollars on defectively priced contracts, including applicable interest and penalties.

Truth in Negotiations Act

The Truth In Negotiations Act, Section 2306a of Title 10, United States Code, requires contractors to submit accurate, complete, and current cost or pricing data to the Government prior to agreement on price during negotiations. Failure by a contractor to comply with the Truth in Negotiations Act can result in the Government reducing the contract by the amount found to be defectively priced and assessing interest and penalties.

Postaward Audits

DCAA performs postaward audits to determine contractor compliance with the Truth in Negotiations Act. Generally, the auditor establishes the existence of defective pricing by examining and analyzing the records and data available to the contractor as of the date of the prime contract price agreement and comparing them with the submitted cost or pricing data. DCAA completes risk assessment/preliminary audit steps to assess the selected pricing action's risk of defective pricing, compiles basic information needed to conduct the audit, performs analytical procedures and plans the nature and extent of probe transaction testing for the major cost elements. The auditor must complete probe transaction testing to ensure that adequate substantive testing has been performed to provide a reasonable basis for an opinion. Detailed audit steps in the program allow the auditor to document additional audit procedures applied to specific cost elements and to gather evidence needed to support an audit conclusion.

DCAA Selection Process

DoD designated DCAA to establish and conduct a program for performing regularly scheduled postaward audits of selected contracts, modifications, subcontracts, and other eligible award pricing actions subject to the Truth in Negotiations Act. The DCAA postaward audit selection system includes four steps:

- establishing and updating the universe of eligible pricing actions,
- making risk determinations for contractors,
- determining the number of required postaward audits, and
- selecting the individual pricing actions to audit for compliance with the Truth In Negotiations Act.

Universe

Each audit office develops and maintains a universe of eligible pricing actions from which it selects individual pricing actions for audit. A complete universe consists of all pricing actions, including negotiated prime contracts, subcontracts, modifications, interdivisional works, final price redeterminations, equitable adjustments, and terminations subject to the Truth in Negotiations Act for which the records retention period has not expired. However, DCAA guidance only requires the audit office to retain each pricing action in its universe for three years. The audit office maintains a universe for each contractor or group of contractors with a separate risk determination.

Risk Determinations

Starting in FY 2008, audit offices assign a risk determination to each individual contractor with more than \$50 million in firm-fixed-price sales. The risk determination considers: (i) the rate of positive occurrence of defective pricing, (ii) amounts of recommended price adjustments, (iii) results of estimating system reviews, and (iv) results of other internal control system reviews to identify the potential risk that contracts may be defectively priced.

Required Postaward Audits

DCAA uses a matrix with contractor risk determinations, contract types, and dollar value strata to determine the number of required defective pricing audits for a given year. At a minimum, for each universe maintained, the audit office must select one pricing action for each dollar stratum that has pricing actions in it. For contractors with a separate low risk determination, the audit office should select a minimum of three pricing actions within a 3-year period. This requirement ensures that some level of postaward audit effort occurs at these contractors.

Defective Pricing Universe and Intercompany Orders

In FY 2007, the Branch Office did not maintain a complete defective pricing universe as required. The Branch Office did not include (b) (4) intercompany orders in the defective pricing universe. DCAA guidance mentions including intercompany or interdivisional work orders in the universe and its standard annual request sent to contractors for a listing of pricing actions subject to TINA also specifically includes interdivisional work. A significant portion of (b) (4) Government sales in FYs 2007 and 2008 were fixed price intercompany orders.²⁵

²⁵ (FOUO) Total Government fixed priced intercompany sales to total Government sales were 45 percent in FY 2007 and 50 percent in FY 2008.

FY 2008 ^{(b) (4)} Defective Pricing Audits

In FY 2007, the Branch Office properly categorized the contractor in a group risk rating. However, in FY 2008, the Branch Office improperly kept ^{(b) (4)} in a group risk determination instead of assigning it a separate risk determination as required by the revised planning guidance. ^{(b) (4)} had over \$ ^{DCAA: (b) (4)} in firm-fixed-price sales in FY 2008, thus qualifying it for a separate risk determination. Based on the information available to us, ^{(b) (4)} would have been assigned a low risk determination. In FY 2008, the audit office selected one ^{(b) (4)} pricing action for review, but subsequently canceled it. In fact, from FY 2006 through FY 2010, the Branch Office selected four²⁶ ^{(b) (4)} pricing actions for review and canceled all of them. Therefore, the Branch Office did not provide the minimum level of coverage, three postaward audits within 3 years, that DCAA guidance requires.

Calculating the Number of Required Defective Pricing Audits

Starting in FY 2008, DCAA planning guidance allowed audit offices to calculate and apply a decrement factor when an audit office was unable to compile an accurate universe of pricing actions in the lower dollar strata. When an audit office cannot verify that each pricing action added to the universe is subject to TINA, the audit office can calculate a decrement factor based on the actual percentage of pricing actions included in the prior year's universe and later found not to be subject to TINA. The decrement factor is applied to the total number of pricing actions in the low dollar strata in the current year's universe. The improper implementation of a decrement combined with a revised DCAA selection process resulted in an 82 percent reduction in the number of required defective pricing audits planned in one stratum (Firm-Fixed-Price, \$650,000 to \$10 million, small high risk contractors) from 11 audits in FY 2007 to 2 audits each in FYs 2008 and 2009. In FYs 2008 and 2009, the supervisor responsible for the defective pricing program did not adequately document, as required, the calculation of a 50 percent decrement; therefore, we are unable to verify that the decrement was properly calculated. In addition, for those years, the supervisor improperly applied the 50 percent decrement to the number of required audits as opposed to the total number of pricing actions resulting in the Branch Office scheduling only two defective pricing audits per stratum.

²⁶ The audit office selected a pricing action in FYs 2006, 2007, 2008 and 2010. No selection was made in FY 2009.

Overall DCAA Postaward Review Coverage

Overall, DCAA postaward audit coverage has steadily decreased to an unacceptable level of coverage. In FY 2008, DCAA completed 26 percent of the scheduled defective pricing audits. In FY 2010, DCAA only completed 66 defective pricing audits or 5 percent of those scheduled. Table G-1 (below) provides additional information.²⁷

Table G-1. DCAA Scheduled and Completed Postaward Audits

| | FY 2008 | FY 2009 | FY 2010 |
|-------------------------|---------|---------|---------|
| Scheduled | 1,366 | 1,119 | 1,450 |
| Completed | 356 | 154 | 66 |
| Percent Complete | 26% | 14% | 5% |

DCAA cannot make up the lack of coverage in subsequent years because its guidance only allows a pricing action to stay in the universe for 3 years, except for mandatory selections. Therefore, the composition of the defective pricing universes will change from year to year and the same pricing actions will not be subject to review each year. Based on the small number of postaward selections being audited, keeping pricing actions in the universe for 5 or more years, instead of just 3 years, would increase the chance that a pricing action is reviewed. This, in turn, would provide better coverage of contractor compliance with TINA and strengthen the defective pricing program.

As part of our oversight and contract audit policy responsibilities, we are currently monitoring DCAA proposals to realign its functional area responsibilities and the types of audits it performs. Under Project No. D2011-DIPOAI-OI03.000, Review of Actions to Align Defense Contract Management Agency and Defense Contract Audit Agency Functions, we are also reviewing actions taken or changes under consideration by the Director, Defense Procurement and Acquisition Policy, to align various functions of the Defense Contract Management Agency and DCAA. This review includes, but is not limited to, the establishment of the revised dollar thresholds for requesting a DCAA audit when evaluating contractor price proposals. On October 18, 2010, DCAA informed its field audit offices that requests for price proposals audits received from contracting officers for cost-type price proposals under \$100 million and fixed-price proposals under \$10 million should be referred to the Defense Contract Management Agency for field pricing support unless exceptional circumstances

²⁷ DCAA postaward coverage has increased since FY 2010. In FY 2011, DCAA completed 33 defective pricing audits or 12 percent of those scheduled. In FY 2012, DCAA completed 39 defective pricing audits or 21 percent of those scheduled. In FY 2013, DCAA completed 32 defective pricing audits or 16 percent of those scheduled.

apply. As a part of the review, we may consider the impact, if any, that the revised dollar thresholds for audit may have had on the DCAA risk-based planning process and the allocation of audit resources to the defective pricing program. Increasing the threshold for price proposal audits could also increase the Government's risk of defective pricing for those price proposals not subject to audit.

Inadequate coverage of contractor compliance with TINA combined with the increase in the price proposal audit threshold could increase the Government's risk that contracts are overpriced. Table G-2 (below) shows the average return on investment of \$2,531 for each hour DCAA charged in performing defective pricing audits for the last three years. The return on investment is calculated based on DCAA recommended price adjustments,²⁸ not negotiated price adjustments, and DCAA hours expended for postaward audits completed in FY 2008 through FY 2010.

Table G-2. DCAA Recommended Price Adjustments and Associated Hours

| | FY 2008 | FY 2009 | FY 2010 | Three-Year Average |
|--|------------------|------------------|------------------|--------------------|
| Recommended Price Adjustment | \$74,168,000 | \$58,601,000 | \$50,817,000 | \$61,195,333 |
| Hours Charged | 21,262 | 38,022 | 13,252 | 24,179 |
| Return on Investment (Recommended Price Adjustment/Hours) | \$3,488 per hour | \$1,541 per hour | \$3,835 per hour | \$2,531 per hour |

DCAA Response to Preliminary Results Memorandum

DCAA did not concur with two recommendations on reviewing Western Region audit offices' defective pricing coverage. A high-level analysis showed that the revised guidance did not result in a similar substantial reduction region-wide in planned defective pricing audits for the one strata and the audit offices had planned the same number or higher of audits for the other stratum. In response to another recommendation, DCAA determined that the revised planning guidance did not result in a significant decrease in the number of planned defective pricing audits agency-wide. DCAA also did not agree to increase the number of (b) (4) pricing actions selected for audit. DCAA stated that the Branch Office did not complete any audits in this stratum in FYs 2008 through 2010 because of higher priority

²⁸ The recommended price adjustment is the total amount the contract price increased because the contractor submitted defective cost or pricing data.

work. Therefore, even if the Branch Office had properly applied the postaward audit selection guidance, the additional audits likely would not have been performed.

Recommendations, Management Comments, and Our Response

Recommendation G.1

We recommend that the Director, DCAA:

- a. Increase FY 2011 and FY 2012 defective pricing audit coverage at any office that did not complete the required number of audits for contractors with separate risk determinations.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, disagreed. DCAA stated that it had insufficient resources to address all the postaward audit requirements based on the existing DCAA postaward audit requirements process. While DCAA recognized the importance of performing postaward audits, it did not have the resourcing capacity to perform all the required audits in accordance with the DCAA planning and audit guidance. DCAA planned to re-assess current postaward requirements process by March 2012. This assessment was to be based on the available resources and the highest risk pricing actions.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- b. Make appropriate revisions to the DCAA planning and audit guidance to ensure that the DCAA defective pricing program is providing adequate coverage on an annual basis.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. By March 2012, DCAA planned to re-assess the defective pricing program to ensure it was providing the appropriate coverage based on the available resources. For the past several years, DCAA had not had the

available resources to perform the defective pricing audits in accordance with the DCAA planning and audit guidance. DCAA expected that this would be the same situation for FY 2012. For FY 2012, DCAA planned to expend the limited resources to complete the higher risk defective pricing audits.

Our Response

The comments from DCAA are responsive. DCAA provided MRD 11-OWD-040(R), "FY 2012 Staff Allocation and Future Plan Guidance," dated August 16, 2011, that prioritized Defense Procurement Acquisition Policy-identified high-risk pricing actions as high-priority postaward audits. No further action on this recommendation is required.

- c. Ensure all audit offices' defective pricing universes include intercompany or interdivisional transfers as required.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed in principle. By December 2011, DCAA planned to issue an audit alert reminding audit offices to include intercompany and interdivisional orders in their defective pricing universes.

Our Response

The comments from DCAA are responsive. DCAA provided the Audit Planning Guide, revision dated July 2012, which included the requirement to include interdivisional work in the defective pricing universe.

- d. Revise defective pricing selection guidance to require that pricing actions subject to defective pricing remain in the universe for at least five planning periods instead of three.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. On April 22, 2011, DCAA headquarters issued Memorandum for Regional Directors 11-OWD-016(R), "Fiscal Year 2012 Requirements Plan Guidance," which required pricing actions subject to defective pricing audits to remain in the universe for 5 years.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- e. Revise existing defective pricing selection process guidance on how long a pricing action should stay in the universe to include consideration of factors or risks other than the number of years already in the universe.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. DCAA planned to re-assess the criteria for retaining pricing actions in the postaward universes during the re-assessment of the DCAA planning and audit guidance for defective pricing audits.

Our Response

The comments from DCAA are responsive. DCAA provided the Audit Planning Guide, revision dated July 2012, which required audit offices to retain each pricing action in the defective pricing universe for five years. No further action on this recommendation is required.

Recommendation G.2

We recommend that the Branch Manager, Central Coast Branch Office:

- a. Assign (b) (4) a separate risk determination during the defective pricing selection process.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, agreed. The (b) (4) North Texas Resident Office had audit cognizance over (b) (4), which included the costs from (b) (4). The (b) (4) North Texas Resident Office was responsible for the assignment of a separate risk determination for (b) (4) during the defective pricing selection process.

Our Response

The comments from DCAA are responsive. No further action on this recommendation is required.

- b. Complete at least three postaward audits on (b) (4) pricing actions in FY 2011 and FY 2012.

Defense Contract Audit Agency Comments

The Deputy Director, DCAA, partially agreed. DCAA stated that it did not have sufficient resources to add additional requirements for FY 2011 at the (b) (4) North Texas Resident Office or the Central Coast Branch Office. DCAA anticipated having sufficient resources to perform at least a portion of the (b) (4) postaward audits required during FY 2012.

Our Response

The comments from DCAA are responsive. DCAA planned and subsequently canceled two postaward audits in FY 2012. DCAA stated that two priority postaward audits were planned in FY 2013; however, they were canceled due to lack of post negotiation memoranda. DCAA does not have any postaward audits planned for FY 2014 due to lack of resources.

Appendix A

Scope and Methodology

We conducted this review from December 2008 through June 2011 in accordance with Audit Policy and Oversight Operating Procedures, which comply with the Quality Standards for Inspection and Evaluation issued by the Council of the Inspectors General on Integrity and Efficiency.²⁹ The project was suspended in January 2010 due to higher priority work and resumed in August 2010. The completion of this report was substantially delayed due to the shift in our review of Hotline allegations to our primary oversight of DCAA audit quality during the period January 2012 – March 2013. Additional review was required to address DCAA comments to the draft report, and update the status of corrective actions taken.

We visited the Suboffice in Goleta, California; the Camarillo Suboffice in Camarillo, California; and the Branch Office in Van Nuys, California; and interviewed 10 DCAA employees including auditors, supervisors, and managers, to assess whether problems concerning the performance of audit work existed. We also interviewed the complainant to clarify the specific allegations and concerns and gather additional information.

Table of Allegations

Table 1 lists the individual allegations, results of the review, and references where the allegations are discussed in the report.

²⁹ The Inspector General Reform Act of 2008 created the Council of the Inspectors General on Integrity and Efficiency (CIGIE) by combining what were formerly known as the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency. The prior version of this publication was issued by the two predecessor organizations in October 2003 and revised by CIGIE in January 2011.

Table 1. Allegations and Conclusions

| No. | Allegation | Conclusion | Reference |
|-----|--------------------------------------|--|------------|
| 1 | Performance of Price Proposal Audits | Further Review Required* | Appendix A |
| 2 | Request for Regional Guidance | Partially Substantiated | Finding E |
| 3 | Inadequate Review of Travel Costs | Partially Substantiated** | Appendix B |
| 4 | Audit Hours Limited by Metrics | Hotline Completion Report (HCR) dated February 9, 2012 | Appendix A |
| 5 | Assist Audit of 2004 Incurred Cost | Partially Substantiated | Finding F |
| 6 | Performance of Floor Check Audits | Substantiated | Finding D |
| 7 | Review of Paid Vouchers | Substantiated | Finding B |
| 8 | Audit Findings Not Reported | Not Substantiated | Appendix B |
| 9 | Unallowable Legal Fees Not Reported | Substantiated | Finding A |
| 10 | Changes to Working Papers | Further Review Required* | Appendix A |
| 11 | Supervisor Meeting with Contractor | Not Substantiated | Appendix B |
| 12 | Documentation of Contractor Data | Partially Substantiated** | Appendix B |
| 13 | Postaward Audit Selection | Partially Substantiated | Finding G |
| 14 | Request for Stock Ownership Plan | Substantiated | Finding C |
| 15 | Classification of Contractors | Not Substantiated | Appendix B |
| 16 | Cancellation of Systems Audits | HCR dated February 27, 2012 | Appendix A |
| 17 | Inadequate Incurred Cost Claims | HCR dated March 1, 2012 | Appendix A |
| 18 | Hotline Review Process | Not Substantiated | Appendix B |
| 19 | Treatment of Auditors | Not Substantiated | Appendix B |
| 20 | IG Planned Review | Not Substantiated | Appendix B |

*Will be reviewed as a separate project.

** No recommendations for this allegation.

We examined DCAA audit documentation for FYs 2004 through 2008 Suboffice audits identified in the complaint. We assessed the audits for compliance with GAGAS versions 2003 and 2007, as applicable, and DCAA policies and procedures.

Table 2. Information on Assignments Reviewed

| No. | Assignment Description | Assignment No. | Report Date | Allegation* |
|-----|-------------------------------|----------------|-------------|-------------|
| 1 | (b) (4) 2004 Incurred Cost | 2004P10100019 | 8/29/2007 | 5 & 12 |
| 2 | (b) (4) 2005 Incurred Cost | 2005N10100007 | 7/18/2008 | 3 & 12 |
| 3 | (b) (4) FY 2005 Incurred Cost | 2005P10100002 | 6/20/2008 | 4 & 17 |
| 4 | (b) (4) FY 2004 Incurred Cost | 2004P10100002 | 9/30/2006 | 4 & 17 |
| 5 | (b) (4) FY 2004 Incurred Cost | 2004P10100007 | 4/27/2007 | 4 & 17 |
| 6 | (b) (4) FY 2005 Incurred Cost | 2005P10100018 | 2/827/2008 | 4 & 17 |
| 7 | (b) (4) FY 2005 Incurred Cost | 2005P10100001 | 12/14/2007 | 4 & 17 |
| 8 | (b) (4) FY 2005 Incurred Cost | 2005N10100004 | 4/25/2008 | 4 & 17 |
| 9 | (b) (4) FY 2005 Incurred Cost | 2005P10100004 | 10/30/2007 | 2 & 14 |
| 10 | (b) (4) FY 2005 Incurred Cost | 2005P10100016 | 3/24/2008 | 8 |
| 11 | (b) (4) FY 2004 Incurred Cost | 2004N10100011 | 6/21/2007 | 11 |
| 12 | (b) (4) FY 2004 Incurred Cost | 2004P10100013 | 9/20/2007 | 9 |
| 13 | (b) (4) Purchasing System | 2006P12030001 | 1/22/2007 | 16 |
| 14 | (b) (4) Budgeting System | 2007P11020001 | 6/29/2007 | 16 |
| 15 | (b) (4) 2006 Floor Check | 2007P10310002 | 1/4/2007 | 6 |
| 16 | (b) (4) 2005 Floor Check | 2005P10310012 | 12/19/2005 | 6 |
| 17 | (b) (4) 2007 Proposal | 2007P21000001 | 11/17/2006 | 1 |
| 18 | (b) (4) 2006 Proposal | 2005P27000011 | 9/13/2005 | 1 |
| 19 | (b) (4) 2008 Proposal | 2008P21000002 | 12/20/2007 | 1 |
| 20 | (b) (4) FY 2005 Paid Voucher | 2005P11015002 | 2/11/2005 | 7 |

*See Table 1 "Allegations and Conclusions".

Preliminary Results Memorandum

Based on additional information provided by the complainant in response to APO Memo No. 2010-CAPO-0107-06, dated September 30, 2010, Evaluation of Defense Hotline Allegations at the DCAA Santa Barbara Suboffice, Project No. D2009-DIP0AC-0107.000, we established separate Hotline case numbers to further evaluate five allegations. See Introduction, Table of Allegations, for a listing of the allegations reviewed under separate projects.

Use of Computer-Processed Data

We did not rely on any computer-processed data as part of our review.

Prior Coverage

During the last 5 years, the GAO and DoD IG have issued 9 reports related to similar issues with DCAA that are addressed in this report. The unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov/>, and unrestricted DoD Inspector General reports can be accessed at <http://www.dodig.mil>.

GAO

Report No. GAO-12-88, "Actions Needed to Improve DCAA's Access to and Use of Defense Company Internal Audit Reports," December 2011

Report No. GAO-09-468, "Widespread Problems with Audit Quality Require Significant Reform," September 2009

DoD IG

Report No. DODIG-2013-044, "Monitoring of the Quality of the Defense Contract Audit Agency FY 2010 Audits," March 7, 2013

Report No. DODIG-2013-015, "Actions to Align Defense Contract Management Agency and Defense Contract Audit Agency Functions," November 13, 2012

Report No. DODIG-2012-038, "Hotline Complaint Concerning Inadequate Audit Services Provided by an Audit Team in the Defense Contract Audit Agency Mid-Atlantic Region," January 10, 2012

Report No. D-2011-6-011, "Report on Hotline Allegations Regarding Lack of Agency Guidance on the Currency of Audit Testing in the Defense Contract Audit Agency," September 21, 2011

Report No. D-2011-6-010, "Report on Failure of Defense Contract Audit Agency, Santa Ana Branch Office, to Provide Adequate Support in Response to a Request for Review of Interim Public Vouchers," September 2, 2011

Report No. D-2011-6-007, "Hotline Allegations Concerning a Field Audit Office in the Defense Contract Audit Agency Central Region," April 15, 2011

Report No. D-2011-6-001, "Hotline Allegations Involving Management Harassment of a Complainant in the Defense Contract Audit Agency Western Region," October 29, 2010

Report No. D-2009-6-009, "Audit Work Deficiencies and Abusive Work Environment Identified by the Government Accountability Office," August 31, 2009

Appendix B

Other Allegations Addressed

Allegations Reassigned

The complainant made other allegations that we referred back to the Defense Hotline and were reassigned to the IG Civilian Reprisal Investigations Directorate under a new Hotline case number.

Review of Travel Costs (Allegation 3)

We partially substantiated the allegation that travel costs were not properly reviewed in Audit Assignment No. 4231-2005N10100007, Audit of (b) (4) 2005 Incurred Costs. Working papers, as mentioned in the complaint, were marked as “in process” for the direct travel costs reviewed for one contract; however, the supervisor still approved this overall section. The supervisor limited the testing to high dollar items because direct travel costs of \$ DCAA: (b) (4) for this contract were immaterial to the total auditable costs of \$ DCAA: (b) (4). The auditor failed to properly document what was tested. Since contractor source documents were not included in the assignment and the working papers were incomplete, we retested the contractor’s source documents and determined that the audit conclusion that the claimed costs were allowable was acceptable. DCAA has implemented various corrective actions, including training on working paper documentation requirements, to address audit quality. See Introduction, “Prior Review Findings and DCAA Corrective Actions,” for more information. We will perform continuous monitoring and oversight reviews of DCAA audits to determine whether DCAA is improving its audit quality.

Audit Findings Not Reported (Allegation 8)

We did not substantiate the allegation that audit findings were not reported in Assignment No. 4231-2005P10100016, Audit of (b) (4) FY 2005 Incurred Cost in order to meet a deadline. The auditor determined that the incurred cost submission was adequate on May 16, 2006 and issued the audit report on March 24, 2008. The auditor met the agency performance metric for completing incurred cost audits within 24 months. The working papers documented an issue concerning subcontractor costs being billed at a higher rate than actually incurred; however, this was disclosed and discussed with the contracting officer who determined it to be allowable per the contract. Therefore, the issue was considered satisfactorily resolved and did not need to be included in the audit report.

Supervisor Meeting with Contractor (Allegation 11)

We did not substantiate the allegation that a supervisor met with the contractor without the auditor regarding his Assignment No. 4231-2004N101000011, Audit of Santa Barbara Infrared FY 2004 Incurred Cost. Documentation as to what was discussed at the meeting was not available. The supervisor stated that the meeting was initiated by the contractor to provide the supervisor and another auditor not familiar with the contractor, an overview of the company and its operations. The supervisor could not provide documentation of what was discussed at the meeting, but the supervisor's statements were confirmed by the other auditor who attended the meeting.

Documentation of Contractor Data (Allegation 12)

We partially substantiated the allegation that many incurred cost audits do not include specific identification of the contractor invoices and documents reviewed. In 2 of 12 incurred cost assignments reviewed, the working papers did not contain detailed information related to the specific transactions tested. For Assignment No. 4231-2005N10100007, Audit of (b) (4) 2005 Incurred Cost (discussed above under Review of Travel Costs), and Assignment No. 4231-2004P10100019, Assist Audit of (b) (4) 2004 Incurred Cost at (b) (4) (discussed in Finding A), we needed to review the original source documents to determine whether the audit performed the testing and reached the correct conclusions as documented in the working papers. Although some of the other 10 incurred cost assignments had weaknesses in documentation, the working papers contained enough evidence to determine that the work was performed. DCAA has implemented various corrective actions, including training on working paper documentation requirements, to address audit quality. See Introduction, "Prior Review Findings and DCAA Corrective Actions," for more information. We will perform continuous monitoring and oversight reviews of DCAA audits to determine whether DCAA is improving its audit quality.

Classification of Contractors (Allegation 15)

We did not substantiate the allegation that major contractors were misclassified as non-major contractors at the Suboffice. The complainant specifically named two contractors as misclassified. The two contractors and all other contractors associated with the review of the 12 incurred cost audits³⁰ were properly classified as non-major

³⁰ Appendix A, Table 2, identifies the contractors for the 12 incurred cost audit assignments selected for review in the individual assignment descriptions.

contractors. At the time the audits were performed, DCAA defined non-major contractors as having \$90 million or less of auditable costs for the year under audit. None of the contractors associated with the 12 assignments reviewed had greater than \$90 million in auditable costs.

Miscellaneous Allegations

We did not substantiate allegations regarding the Defense Hotline review process, preferential treatment of some auditors, and a cancelled DoD IG planned review. The complainant alleged that Defense Hotline complaints were given to DCAA for review, that select auditors were allowed to excessively charge indirect time, and a DoD IG-planned review never took place because DCAA objected to the review.

Hotline Review Process (Allegation 18)

We did not substantiate the allegation that DCAA auditors were deterred from reporting fraud, waste, abuse, and mismanagement because Defense Hotline complaints made by DCAA auditors were being reviewed by DCAA Headquarters or the regional audit offices where the complaint originated. DoD Instruction 7050.01, "Defense Hotline Program," dated December 17, 2007, prescribes the procedures for operation of the Defense Hotline. The Defense Hotline refers a complaint to the appropriate DoD Component who then is to perform an independent and objective evaluation. The Component then submits a Defense Hotline Completion Report to the Hotline which reviews the report for completeness. When deemed appropriate, Defense Hotline complaints are forwarded to DCAA Headquarters for review. In September 2008, the Defense Hotline temporarily stopped referring complaints on DCAA to DCAA Headquarters for review. In 2010 and 2011, this office received approximately 49 complaints concerning DCAA that were directly submitted to the Defense Hotline. There is no evidence to suggest that the process deterred auditors from making Defense Hotline complaints.

Treatment of Auditors (Allegation 19)

We did not substantiate the allegation that between FYs 2002 and 2007, some auditors received preferential treatment including being allowed to charge excessive hours to six direct and indirect activity codes, exceed audit budgets, and extend assignment due dates. The six activity codes identified by the complainant were: Office Monitors, Monitoring/Tracking, Permanent File, Participative Work Team, Other Direct, and Administration and Support. The time charging patterns among the auditors did not show significant differences. Instead, the time charging practices for all of

the previously mentioned activity codes at the Suboffice remained consistent with DCAA description of activities that should be charged to the codes. Hours charged to the activity codes varied among the auditors from year to year. The Suboffice does not assign auditors to perform the activities on an ongoing basis. Instead, the activities are assigned and performed on an as-needed basis, dependent on the contractor under audit and Suboffice needs. Suboffice personnel stated that some contractors required more monitoring and permanent file maintenance than others, and that Participative Work Team activities varied depending on the tasks that auditors volunteer to perform at the discretion or approval of the supervisor. In addition, no evidence exists in the 12 audits reviewed that auditors inappropriately exceeded their audit budgets or extended assignment due dates.

IG-Planned Review (Allegation 20)

We did not substantiate the allegation that a DoD IG-planned review of DCAA auditor compliance with GAGAS in relation to performance ratings was never performed due to DCAA objections. The complainant stated that DCAA Headquarters issued a memorandum advising its auditors of the pending DoD IG review in the early to mid-1990's. Neither the complainant nor DCAA Headquarters could provide details from the memorandum such as when the review was to take place, the scope of review, or the offices to be visited. No record exists of an oversight review with the named objective in the available DoD IG Audit Policy and Oversight project documents.

Management Comments

Defense Contract Audit Agency



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

OFFICE OF THE DIRECTOR

August 29, 2011

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, AUDIT POLICY AND
OVERSIGHT, OFFICE OF THE INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft
Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit
Agency Santa Barbara Suboffice (Project No. D2009-DIPOAC-0107.000)*, dated
July 18, 2011

Thank you for the opportunity to provide comments to your draft report, *Evaluation of
Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice*,
reference Project No. D2009-DIPOAC-0107.00, dated July 18, 2011. The following are
DCAA's comments and responses to each of the recommendations provided in your draft report.
Please note that due to the volume of the requested information in your recommendations, we
will provide this information under separate cover as stated in our responses.

**FINDING A. UNALLOWABLE LEGAL FEES DISCOVERED AND NOT REPORTED IN
AN INCURRED COST AUDIT (ALLEGATION 9):**

DoDIG Recommendation A:

1. The Director, DCAA provide to this office written products documenting:

- a. The Headquarters review of the FY 2003 and FY 2005 ^{(b) (4)} [REDACTED] incurred cost audits and any resulting actions taken.
- b. The analysis of the next incurred cost audit performed at the 22 contractors who have auditable contracts ongoing. The product should also explain whether additional testing was performed in prior years' audits based on the findings from the current year audit.
- c. The analysis of the 8 contractors that have no current auditable contracts to determine whether contracts are still open that were audited in prior years.
- d. Any quality assurance review performed on the 54 incurred cost audits identified as performed by the same audit staff and management who performed the FY 2004 ^{(b) (4)} [REDACTED] ^{(b) (4)} [REDACTED] incurred cost audit.
- e. The Western Region agreed-to training for the Branch Office and the Santa Barbara Suboffice staffs with a verification that the provided training covered the issues identified in this finding in sufficient detail.
- f. The Western Region assessment of its audit staff and management involved with Audit Assignment No. 4231-2004P10100013 accurately reflecting the training required and that the staff and management have either received or are scheduled to receive the required training in FY 2011.

~~FOR OFFICIAL USE ONLY~~

~~FOR OFFICIAL USE ONLY~~

Defense Contract Audit Agency (cont'd)

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice (Project No. D2009-DIP0AC-0107.000)*, dated July 18, 2011

2. The Regional Director, Western Region provide to this office:
 - a. Written product documenting his staff's determination of the appropriate actions needed to correct any identified performance deficiencies for the audit staff and management who worked on the FY 2004^{(b) (4)} incurred cost audit.
 - b. An action plan detailing the identified actions with the estimated completion dates.
3. The Branch Manager, Central Coast Branch Office:
 - a. Provide to this office, a copy of the memorandum rescinding Audit Report No. 4231-2004P10100013.
 - b. Perform additional testing on the contractor's claimed FY 2004 and FY 2005 direct costs, addressing the risk factor that the contractor may have charged costs into the wrong account, and provide a written report to this office.
 - c. Provide to this office copies of the written request to^{(b) (4)} to abrogate its signed rate agreements for FYs 2004 through 2006 indirect rates and the contractor's written response.
 - d. Perform additional testing of FYs 2004 through 2006^{(b) (4)} indirect costs when the contractor agrees to abrogate the negotiated rate agreements for those years.
 - e. Provide to this office the re-issued Audit Report No. 4231-2004P10100013 that incorporated the identified expressly unallowable cost and the results of additional testing of direct and indirect cost accounts.
 - f. Place a memorandum in the audit file stating that the audit is not an acceptable example of an incurred cost audit and cannot be used in future audit planning to assess risk at less than maximum for each of the 54 audits performed by the same audit staff and management as performed the FY 2004^{(b) (4)} incurred cost audit for which a quality assurance review is not performed or for which additional testing is not performed.
 - g. Provide to this office, copies of all memorandums placed in the audit files as required by the prior recommendation.

DCAA Responses/Corrective Actions to Recommendation A:

1.a. Concur. The DCAA Quality Assurance and Integrity Directorate (Q) performed a review of the FY 2003 and FY 2005^{(b) (4)} incurred cost audits and reported the findings in DCAA Memorandum Q 225.4, dated June 30, 2011. The quality review noted significant deficiencies in the planning and performance of these audits and recommended that both reports be rescinded. The FAO rescinded both the 2003 and 2005 audit reports on July 11, 2011. As requested, we previously provided your office with a copy of the quality review report.

Defense Contract Audit Agency (cont'd)

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice* (Project No. D2009-DIP0AC-0107.000), dated July 18, 2011

1.b. Concur. As originally stated in our December 22, 2010 response to your preliminary review results, the FAO will perform an audit, rather than desk reviews, of the next open contractor fiscal year incurred cost submission at each of the 22 contractors that have ongoing flexibly-priced contracts. If significant issues are identified during these audits, we will determine whether the potential exists that similar issues are present in prior audited years. If so, the FAO will perform additional testing on those prior audited years, if the cost reimbursable contracts in those prior years have not yet been closed. Due to resourcing constraints and the prioritization of our workload, we have not yet performed the audits of the next open contractor fiscal year at the subject contractors as identified below. Therefore, we have not yet determined whether additional testing in any of the prior years is warranted at any of these contractor locations. We are currently in the process of developing our program plan for FY 2012. We anticipate prioritizing these audits during the coming year. As we complete our FY 2012 plan, we would be pleased to share our plan, including estimated completion dates with your office. We expect to have the program plan completed by September 30, 2011.

| CONTRACTOR | CFY | NOTE |
|------------|------|------|
| (b) (4) | 2007 | |
| | 2006 | |
| | 2006 | |
| | 2006 | |
| | 2008 | |
| | 2006 | |
| | 2007 | (a) |
| | 2006 | (b) |
| | 2007 | |
| | 2007 | |
| | 2007 | |
| | 2007 | |
| | 2006 | |
| | 2006 | |
| | 2010 | (c) |
| | 2007 | |
| | 2005 | |
| | 2006 | |
| | 2004 | |
| | 2007 | (d) |
| | 2006 | |
| | 2006 | |

Defense Contract Audit Agency (cont'd)

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice (Project No. D2009-DIP0AC-0107.000)*, dated July 18, 2011

- (a) Beginning with FY 2007, (b) (4) was consolidated within the (b) (4) and is no longer required to submit a separate incurred cost claim. The Central Region's Salt Lake Valley Branch Office is cognizant of the (b) (4) and has requested the assistance of the Central Coast Branch Office to evaluate the (b) (4) portion of the claim.
- (b) (b) (4) relocated during FY 2006 from Southern California to Colorado. As such, we have notified the DCAA Rocky Mountain Branch Office that a full audit is required for FY 2006 and that if any significant issues are identified during the audit the FAO should determine whether the potential exists that similar issues are present in prior audited years. If so, the FAO will perform additional testing in those prior audited years if the cost reimbursable contracts in those prior years have not been closed.
- (c) (b) (4) did not have any flexibly-priced contracts during FYs 2007-2009.
- (d) For FY 2007 and beyond, the Pennsylvania Branch Office (PBO) has audit cognizance of (b) (4). We have notified the Pennsylvania Branch Office that a full audit is required for FY 2007 and that if any significant issues are identified during the audit, the FAO should determine whether the potential exists that similar issues are present in prior audited years. If so, the FAO will perform additional testing in those prior audited years if the cost reimbursable contracts in those prior years have not been closed.

1.c. Concur. We have previously provided our analysis to your office of the eight contractors that no longer have current auditable contracts. Based on this analysis, it was determined that five of the eight contractors still have open contracts with significant unsettled costs. Our Q Directorate performed an assessment of the audits at four of these contractor locations, (b) (4) reference DCAA Memorandum Q 225.4, dated June 30, 2011. The quality review noted significant deficiencies in the planning and performance of the 2003 and 2004 (b) (4) incurred cost audits and the 2003, 2004, and 2005 (b) (4) incurred cost audits. Each of these five reports were rescinded on July 11, 2011. The quality review did not take exception to the work performed on the 2003 and 2004 (b) (4) and (b) (4) incurred cost claims as each of these years were evaluated using desk review procedures.

The Central Coast Branch Office performed further analysis of the contracts with (b) (4) and subsequent to the Q review discussed above, determined that contracts with significant costs were still open. Independently, the FAO recently performed an analysis of the 2005 incurred cost audit and found similar conditions as noted by our Quality Directorate. As such, the FAO will rescind the 2005 (b) (4) audit report as well.

Defense Contract Audit Agency (cont'd)

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice (Project No. D2009-DIP0AC-0107.000)*, dated July 18, 2011

1.d. Concur. As noted above, we previously provided your office with a copy of the Quality Assurance and Integrity Directorate's review, dated June 30, 2011, reference Q 225.4. In this report, DCAA addressed the reviews of the adequacy of the audit quality of work performed specific to recommendations (and/or sub-recommendations) 1(a), 2(a), 3(a)(1), 3(a)(3), 6(a), 6(b), and 9, as made in your preliminary draft report, dated September 30, 2010.

1.e. Concur. Over the last several months, we have provided mandatory training to all DCAA audit staff aimed at improving the quality of our audits. In particular, the CCBO audit staff and management have received the following training over the last several months:

- In March 2009, all CCBO employees completed working paper training provided by the Western Region's Technical Programs Division.
- During the first quarter of FY 2010, all CCBO staff completed DCAI's Working Paper Documentation training CMTL 1269.
- On August 24, 2010, the CCBO staff received training on incurred cost adequacy during the CCBO fourth quarter staff conference.
- During fourth quarter 2010, all CCBO audit staff completed DCAI's GAGAS training (CMTL 1440).
- On December 1, 2010, all CCBO received training on DCAA's recently revised variable and attribute sampling policy from the Western Region's Technical Programs Division.
- In April 2010, CCBO staff received the 3-day GAGAS training provided by DCAA's Integrity and Quality Assurance Directorate (Q).
- On June 15, 2011, all CCBO staff received training on the specific audit quality issues identified by the DoDIG.

1.f. Concur. As noted in our response to your preliminary results dated December 22, 2010, the supervisor who signed virtually all the reports identified in your draft report and provided the day-to-day direction to the auditors performing these audits is no longer employed by DCAA. The remaining employees have received significant training over the last several months aimed at improving the overall audit quality within the FAO as well as across the Agency. In addition, we have clearly communicated our expectations to the workforce in regards to performing quality audits, in accordance with Generally Accepted Government Auditing Standards. Lastly, the specific auditors and management staff who are still employed by DCAA and performed significant effort on any of the assignments addressed in your report have been specifically counseled in relation to those audits.

2.a. Concur. We have provided to your office our memorandum addressing the actions taken to address the performance of the audit staff who worked on the 2004 Pacific Advanced Technologies incurred cost audit. Our memorandum notes our belief that the counseling provided to the auditor, along with the additional training, guidance and communication of expectations as previously discussed, is sufficient to address the audit performance concerns identified in your report.

Defense Contract Audit Agency (cont'd)

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice (Project No. D2009-DIP0AC-0107.000)*, dated July 18, 2011

2.b. Concur. We are currently in the process of developing our program plan for FY 2012. We anticipate prioritizing the additional audit work previously discussed during the coming year. As we complete our FY 2012 plan, we would be pleased to share our plan, including estimated completion dates with your office. We expect to have the program plan completed by September 30, 2011.

3.a. Concur. On January 26, 2011, we issued a memorandum to the Administrative Contracting Officer (ACO) rescinding (b) (4) Audit Report Number 4231-2004P10100013.

3.b. Concur. We are in the process of completing our fieldwork related to the additional direct cost testing of (b) (4) FY 2004 and FY 2005 incurred cost submissions. We expect to issue our revised report by September 30, 2011, at which time we will provide a copy to your office.

3.c. Partially Concur. On February 8, 2011, we approached (b) (4) regarding their willingness to abrogate its FY 2004 and FY 2005 indirect rate agreements. (b) (4) responded, in writing, on February 14, 2011 refusing to abrogate the agreements noting their opinion that the agreed to "rates are appropriate" for those years. As it relates to the 2006 rates agreement, as previously stated in our December 22, 2010 response to your preliminary findings, we disagree that our review of (b) (4) FY 2006 incurred costs was inappropriately performed as a desk review given that the only flexibly-priced contract performed in 2006 was Contract (b) (4) which had a cost ceiling of \$(b) (4) DCAA: (b) (4), and by the end of CY 2006 was overrun by \$(b) (4) DCAA: (b) (4). Thus, we have not rescinded the FY 2006 desk review memo nor have we requested abrogation of the FY 2006 rate agreement from PAT.

3.d. Not Applicable. As noted above, (b) (4) refused to abrogate the FY 2004 and FY 2005 indirect rate agreements and we do not believe there is sufficient risk related to the 2006 indirect rate agreement to necessitate its abrogation. Therefore, we will not perform additional testing of indirect costs for these years as the associated final indirect rates are binding.

3.e. Concur. As noted in our response to 3.b. above, we are in the process of completing our field work in regards to additional direct cost testing. Upon completion of the additional testing, we will issue a supplemental report on (b) (4) 2004 incurred cost submission, which incorporates the expressly unallowable costs within the audit opinion. We anticipate issuing our final report by September 30, 2011, at which time we will provide a copy to your office.

3.f. Partially Concur. Fourteen of the assignments identified as performed by the same audit staff and management are desk review assignments. Desk reviews consist of analytical procedures and are not considered an audit. As such, we do not use these assignments in future audit planning to assess risk. Therefore, we do not believe that it is necessary to include a

Defense Contract Audit Agency (cont'd)

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice (Project No. D2009-DIP0AC-0107.000)*, dated July 18, 2011

memorandum in those desk review files to indicate that “the audit is not an acceptable example of an incurred cost audit and cannot be relied upon.” For those audits performed by the same audit staff and management as performed the FY 2004 ^{(b) (4)} incurred cost audit and for which additional testing was not performed, a memorandum has been placed in those files stating that subsequent oversight reviews have called into question the sufficiency of these audits and they should not be used as an acceptable example of an incurred cost audit and cannot be used in future audit planning to assess risk at less than maximum. We have provided to your office a reconciliation of the 54 assignments identifying which were conducted as a desk review and which were considered an audit for which the subject memorandum has been placed within the file.

3.g. As noted above, we have provided to your office a reconciliation of the 54 assignments identifying which assignments contain a memorandum noting that the audit should not be relied upon for future planning purposes along with an example of the subject memorandum.

FINDING B. PAID VOUCHER REVIEWS (ALLEGATION 7) CCBO Responses/Corrective Actions to DoDIG Recommendation B:

DoDIG Recommendation B:

The Branch Manager, Central Coast Branch Office:

1. Provide a copy to this office of the Memorandum for Record rescinding the memorandum for record written for Assignment No. 4231-2005P11015002.
2. Provide a copy to this office of the memorandum placed in the assignment file stating that the work should not be relied on or used as an example to perform another paid voucher review.
3. Conduct another paid voucher review covering a representative sample of contracts to ensure that the contractor is billing only allowable costs by the agreed-to date of September 30, 2011.
4. Provide to this office a copy of the written product and working papers documenting the ^{(b) (4)} paid voucher review when completed.
5. Provide written documentation to this office showing:
 - a. the ^{(b) (4)} T&M contracts identified by the Branch Office that have billing instructions that do not comply with DFARS 242.803;
 - b. the written notification to the contracting officer(s) that the contract(s) should be modified to provide for DCAA provisional approval of interim vouchers; and
 - c. copies of the modification to the contract(s) for the revised billing instructions.

DCAA Responses/Corrective Actions to Recommendation B:

1. Concur. On January 26, 2011, we issued a memorandum noting the rescission of the ^{(b) (4)} paid voucher review conducted under Assignment No. 4231-2005P11015002.

Defense Contract Audit Agency (cont'd)

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice (Project No. D2009-DIP0AC-0107.000)*, dated July 18, 2011

2. Concur. On January 26, 2011, a memorandum was placed within the (b) (4) paid voucher review, Assignment No. 4231-2005P11015002, which included language noting that it should not be relied on or used as an example to perform another paid voucher review.

3. Concur. We have established Assignment No. 4431-2011P11015006 to perform another paid voucher review at (b) (4). This review is in process and is expected to be completed by November 11, 2011.

4. Concur. DCAA will provide to your office a copy of our final assignment memorandum and associated working papers upon the completion of the current (b) (4) paid voucher review being performed under Assignment No. 4431-2011P11015006.

5.a. Concur. The CCBO performed an analysis of the billing instructions contained in (b) (4) T&M contracts. CCBO determined that the contract billing instructions comply with the criteria in DFARS 242.803.

5.b. N/A –CCBO did not identify any non-compliant billing instructions.

5.c. N/A –CCBO did not identify any non-compliant billing instructions.

FINDING C. REQUEST FOR EMPLOYEE STOCK OWNERSHIP PLAN (ALLEGATION 14):

DoDIG Recommendation C:

1. The Director, DCAA:

- a. Provide to this office the DCAA Headquarters Quality Assurance report of its review of the FYs 2003, 2004, and 2004 (b) (4) incurred cost audits.
- b. Revise the existing internal control questionnaire to include a question identifying all related parties and any material related-party transactions.

2. The Regional Director, Western Region provide to this office:

- a. The estimated completion date(s) for the (b) (4) FY 2006 and 2007 incurred cost audits.
- b. The estimated completion date(s) of the Western Region assessment of the (b) (4) (b) (4) FY 2006 and 2007 incurred cost audits.
- c. A written product detailing the Western Region's assessment of the (b) (4) Inc. FY 2006 and 2007 incurred cost audits and its results.

Defense Contract Audit Agency (cont'd)

SUBJECT: Response to Department of Defense Office of Inspector General (DoDIG) Draft Report *Evaluation of Defense Hotline Allegations at the Defense Contract Audit Agency Santa Barbara Suboffice (Project No. D2009-DIP0AC-0107.000)*, dated July 18, 2011

- d. A written product documenting the Western Region Technical Programs Division review of the audit specific guidance provided to field audit staff to verify that the guidance was included in the applicable audit working paper files.

DCAA Responses/Corrective Actions to Recommendation C:

- 1.a. Concur. The DCAA Quality Assurance and Integrity Directorate (Q) performed quality assurance reviews of the (b) (4) FY 2003, 2004, and 2005 incurred cost audits and issued the results in its June 30, 2011 Memorandum, reference Q 225.4. The quality review recommended rescission of all three (b) (4) incurred cost audits. The Central Coast Branch Office issued one rescission memo addressing all three reports on July 11, 2011.
- 1.b. Concur. By December 2011, DCAA will revise the internal control questionnaire to include a requirement for the contractor to identify related parties and any material related-party transactions.
- 2.a. Concur. We are currently in the process of developing our program plan for FY 2012. We anticipate prioritizing the completion of the 2006 and 2007 (b) (4) incurred cost audits during the coming year as the field work associated with these audits is not yet complete. As we complete our FY 2012 plan, we would be pleased to share our plan, including estimated completion dates with your office. We expect to have the program plan completed by September 30, 2011.
- 2.b. Concur. As previously noted, over the last several months we have emphasized expectations regarding sufficient testing to support our audit opinions. The 2006 and 2007 (b) (4) incurred cost audits remain open with additional field work to be completed. The Western Region will perform an assessment of the in process audit by October 30, 2011, to ensure that sufficient testing is planned prior to completion of the audit.
- 2.c. Concur. As stated in 2.b. above, we will complete our assessment by October 2011 and will provide a copy of the assessment to the DoDIG.
- 2.d. Concur. The Western Region Technical Programs Division reviewed selected regional guidance to confirm whether the guidance had been documented in audit assignments. The review found that the majority of audits appropriately documented regional guidance; however, improvements are desired. Therefore, the Regional Technical Programs Division (RST) will implement the following process improvements:
 - Formal guidance memorandums will include a statement reminding FAOs to include a copy of the formal guidance in their working papers while also requesting that they send audit reports and other documents related to the guidance to the Regional office.

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- Informal audit guidance will be documented in an e-mail to the FAO, including confirmation of verbal guidance. The (b)(4) e-mail will include a reminder that the guidance, albeit informal, should be documented in the audit working papers.

FINDING D. FLOORCHECK AUDIT (ALLEGATION 6):

DoDIG Recommendation D:

1. The Director, DCAA:

- a. Provide written documentation to this office of the additional guidance provided to the field audit offices on performing floor checks and labor interviews, and the guidelines on the number of employees to be interviewed for different audit circumstances.
- b. Provide to this office, a copy of the revised labor floor check standard audit program that includes an audit step to verify the work products observed during interviews be traced to contract requirements.
- c. Provide to this office, by the agreed-to date of June 30, 2011, all revised standard audit report formats and appropriate Contract Audit Manual sections that require distribution of the report or memorandum to higher-tier DCAA audit offices, when appropriate.
- d. Perform quality assurance reviews of the 2006, 2007, 2008, and 2009 (b)(4) incurred cost audits when completed to ensure sufficient testing of labor costs was performed. Provide a copy of the written quality assurance review report to this office when completed.
- e. Perform a quality assurance review of the Central Coast Branch Office comprehensive labor audit of (b)(4) when completed. Provide a copy of the written quality assurance review report to this office when completed.

2. The Regional Director, Northeastern Region:

- a. Provide written documentation to this office verifying that the (b)(4) Texas increased labor testing in the 2006, 2007, 2008, and 2009 (b)(4) incurred cost audits to take into account the deficiencies in and the results of the (b)(4) labor floor checks for those years.
- b. Provide written documentation to this office verifying that the (b)(4) Texas appropriately considered the deficiencies identified by the (b)(4) labor floor checks when planning related (b)(4) audits.

3. The Branch Manager, Central Coast Branch Office:

- a. Provide a copy of the memorandums rescinding Audit Report Nos. 4231-2007P10310002, 4231-2008P1030020, and 4231-2009P10310010 to this office.

Defense Contract Audit Agency (cont'd)

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- b. Provide a copy of the notification memorandums sent to all recipients of the above listed audit reports informing them that the reports have been rescinded to this office.
- c. Provide a copy of the memorandums inserted in the three audit files listed above documenting that the assignments did not comply with GAGAS and should not be used as examples when conducting a floor check audit to this office.
- d. Provide written documentation to this office verifying the Branch Office performed the agreed-to increased labor testing in the (b) (4) 2006, 2007, 2008, and 2009 incurred cost audits.
- e. Perform a comprehensive labor audit at (b) (4) as soon as possible, and provide the report to this office.

DCAA Responses/Corrective Actions to Recommendation D:

1.a. Concur. As noted in our December 22, 2010 response to your preliminary review results, this action was accomplished on October 20, 2010 when DCAA issued new policy on attribute sampling (MRD 10-OTS-069(R)). The revised policy includes guidance on establishing sample sizes. We are assessing the need for additional floor check guidance and will advise the DoDIG on the results of this assessment.

1.b. Concur. DCAA is expected to complete this revision by December 2011. We will provide a copy of this revised floor check questionnaire to the DoDIG upon completion.

1.c. Concur. DCAA's actions to revise the Contract Audit Manual sections that require distribution of the report or memorandum to the higher-tier DCAA audit offices are still in process. We expect to complete this action by October 2011.

1.d. Concur in Principle. The audits of the 2006-2009 (b) (4) incurred costs have not yet been started. Therefore, it would appear premature that we would commit to perform a post quality review of these audits at this time. Instead, we will ensure that these audits are subjected to a pre-issuance Independent Referencing Review following the Agency's existing policy to ensure that the planning and execution of these audits resulted in sufficient testing to support the audit opinion. These audits may still be selected for post quality review in accordance with existing Agency guidelines. Also, please note that the (b) (4) 2006-2009 incurred costs are included in the consolidated (b) (4) incurred cost submissions. The 2006-2009 NCS incurred cost audits will be performed by the DCAA (b) (4) North Texas Resident Office.

1.e. Concur in Principle. We are performing a comprehensive labor audit at (b) (4) including procedures performed at the (b) (4) site as (b) (4) does not maintain its own labor accounting system. We have not yet completed this audit. As previously stated, we believe that it is premature to commit to perform a post quality review at this time. Instead, we will ensure that this audit is subjected to a

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pre-issuance Independent Referencing Review to ensure that the planning and execution resulted in sufficient testing to support the audit opinion. Again, this audit may still be selected for post quality review in accordance with existing Agency guidelines. We expect to complete this comprehensive labor audit by January 2012.

2.a. Concur in Principle. As noted above, the audits of the 2006-2009 (b)(4) incurred costs have not yet been started as the costs are included in the consolidated (b)(4) incurred cost submissions. The 2006-2009 (b)(4) incurred cost audits will be performed by the DCAA (b)(4) North Texas Resident Office. On January 26, 2011, the Central Coast Branch Office provided a memorandum to the Resident Auditor of the (b)(4) North Texas Resident Office, which instructs them to perform increased labor testing as part of the 2006-2009 (b)(4) incurred cost audits. The increased testing in the incurred cost audits is due to the fact that there was insufficient testing in the rescinded floor check audits conducted by the Central Coast Branch Office.

2.b. Concur in Principle. Please see our response to 2.a. above which notes that the Central Coast Branch Office informed the (b)(4) North Texas Resident Office of the need to increase labor testing when they perform the 2006-2009 incurred cost audits of (b)(4) Systems.

3.a. Concur. On January 26, 2011, the CCBO notified both the original report recipient (DCMA Los Angeles) and the DCAA (b)(4) North Texas Resident Office that it had rescinded the (b)(4) floor check reviews reported in Audit Report Numbers 4231-2007P10310002, 4231-2008P10310020, and 4231-2009P10310010.

3.b. Concur. See our response to 3.a. above.

3.c. Concur. We have included an MFR, dated January 26, 2011, in the working papers files which states that Assignment Nos. 4231-2007P10310002, 4231-2008P10310020 and 4231-2009P10310010 did not comply with GAGAS and should not be used as examples when conducting a floor check.

3.d. Concur. Please see our response to 2.a. above which notes that the Central Coast Branch Office informed the (b)(4) North Texas Resident Office of the need to increase labor testing when they perform the 2006-2009 incurred cost audits of (b)(4). These audits have not yet been started. We are currently in the process of developing our program plan for FY 2012. As we complete our FY 2012 plan, we would be pleased to share our plan, including any estimated completion dates with your office. We expect to complete our program plan by September 30, 2011.

3.e. Concur. As noted above, we are currently performing a comprehensive labor audit at (b)(4) including procedures performed at the (b)(4) site. Once completed, we will provide a copy of our results to your office.

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FINDING E. REQUEST FOR REGIONAL GUIDANCE (ALLEGATION 2):

DoDIG recommendation E:

The DoDIG recommends that the Regional Director, Western Region:

1. Revise the Western Region Instruction Number 7640.24, Requesting and Processing Requests for Regional Technical Guidance, dated September 18, 2009:
 - a. to allow field audit staff, including the auditor, audit office technical specialist, and supervisory auditor to request formal and informal technical guidance directly from the Special Programs Office without management approval;
 - b. to receive the requested guidance directly from the Special Programs Office; and
 - c. to be provided status updates on the submitted requests.
2. Provide to DoDIG written documentation of:
 - a. the actions taken by the Western Region Special Programs Manager to emphasize to the regional technical specialists the importance of working up front with audit offices to facilitate receipt of complete requests for regional guidance, and
 - b. the actions taken by the Western Region management to emphasize to its managers the importance of keeping their audit teams informed on communications with the regional office on their guidance requests.

DCAA Responses/Corrective Actions to Recommendation E:

1.a. Do Not Concur. We believe that our audit staff should seek their primary guidance through their chain of command as supplemented by our field technical specialists as an additional resource located in many of our Field Audit Offices. Our current processes established for obtaining guidance helps to facilitate adequately managed and supervised audits. In addition, we have appropriate safeguards in place to address those situations where there are disagreements between the auditors and their management on significant audit issues, which could include situations where disagreements exist on whether to obtain formal technical guidance.

1.b. Do Not Concur. Please see our response to recommendation 1.a. above.

1.c. Concur in Principle. Provision 6.f(2) of WRI 7640.24, dated September 18, 2009, provides that the Regional Special Programs Manager (RSPM) is responsible for "Keeping regional management, the FAO manager, and RAM informed of significant developments and the status of these activities." We believe that this requirement fully reflects the expectation that the RSPM keep the local audit staff apprised of significant developments as it relates to requests for audit guidance. However, as stated in our December 22, 2010 response to your preliminary

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review results, we do agree to emphasize to our field office managers the importance of keeping their audit teams informed on communications with the regional office on their guidance requests. As noted in our responses 2.a and 2.b below, we will communicate this expectation by October 31, 2011.

2.a. Concur. By October 31, 2011, we will re-emphasize to the Western Region's regional technical specialists the importance of working up front with the audit offices to facilitate the receipt of complete requests for guidance and provide your office with a record of that discussion.

2.b. Concur. By October 31, 2011, we will re-emphasize to the Western Region field office managers the importance of keeping their audit staff informed on communications with the regional office on their guidance requests and provide your office with a record of that discussion.

FINDING F. ASSIST AUDIT OF RAYTHEON VISION SYSTEMS 2004 INCURRED COST (ALLEGATION 5):

DoDIG Recommendation F:

1 The Director, DCAA:

- a. Review the completed 2003 (b) (4) incurred cost audit to verify that sufficient testing was performed to support the audit report conclusions and opinions. Provide to this office a written product documenting the review and its results.
- b. Review the completed 2004 (b) (4) incurred cost audit to verify that sufficient testing was performed to support the audit report conclusions and opinions. Provide to this office a written product documenting the review and its results.
- c. Provide written documentation to this office of the agreed-to assessment of the 2005 (b) (4) incurred cost audit to determine whether additional testing is needed.
- d. Provide written documentation to this office of the agreed-to assessment of the (b) (4) (b) (4) Texas audit of (b) (4) 2004 incurred cost audit to determine whether the audit complied with government auditing standards, in particular, to ensure that sufficient testing was performed to support the audit opinion.
- e. Provide written documentation to this office of the Western Region agreed-to training to the Branch Office and the Santa Barbara Suboffice staffs and verification that the provided training covered the appropriate issues in sufficient detail.
- f. Provide written documentation to this office of the Western Region assessment of audit staff and management involved with Audit Assignment No. 4231-2004P10100019 accurately reflected the training required and that the staff and management have either received or are scheduled to receive the required training in FY 2011.

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- g. Provide written documentation to this office of the Northeastern Region assessment of audit staff and management involved with Audit Assignment No. 3561-2004S10100001 accurately reflected the training required and that the staff and management have either received or are scheduled to receive the required training in FY 2011.
 - h. Provide written documentation to this office of the Northeastern Region agreed-to training to the (b) (4) Texas, verifying that the provided training covered the appropriate issues in sufficient detail.
- 2. The Branch Manager, Central Coast Branch Office, Western Region:
 - a. Provide a copy of the notification to the contracting officer and the (b) (4) (b) (4) Texas that additional testing must be done on the 2004 (b) (4) (b) (4) incurred cost audit and that additional work may be required for the 2005 incurred cost audit.
 - b. Perform the originally planned testing of direct material costs, any additional testing of materials identified by the Headquarters review, and additional testing of direct labor costs under Assignment No. 4231-2004P10100019, issue a supplemental report by the agreed-to date of June 30, 2011, and provide a copy of the report to this office.
 - c. Perform any additional testing identified during Headquarters review of the 2005 (b) (4) incurred cost audit and issue a supplemental audit report, if needed, by the agreed-to date of December 31, 2011, and provide a copy of the report to this office.
- 3. The Resident Auditor, (b) (4) Resident Office, Northeastern Region:
 - a. Provide a copy of the notification to the contracting officer and other audit offices involved that additional testing had to be done on the 2004 (b) (4) (b) (4) incurred cost audit and that additional work may be required for the 2005 (b) (4) incurred cost audit.
 - b. Perform any additional testing identified during the Headquarters review of the 2004 (b) (4) incurred cost audit, issue a supplemental report by the agreed-to date of December 31, 2011, and provide a copy of the report to this office.
 - c. Incorporate the results of any supplemental report issued by the Central Coast Branch Office on the 2004 and 2005 (b) (4) incurred cost audits, issue supplemental reports by the agreed-to date of December 31, 2011, and provide a copy of the report to this office.

DCAA Responses/Corrective Actions to Recommendation F:

- 1.a. Concur in Principle. As noted in our December 22, 2010 response to your preliminary review results, the 2003 (b) (4) (b) (4) incurred cost audit has not been completed. This audit includes the costs of the 2003 (b) (4) incurred costs and is under the responsibility of

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our Golden State Branch Office, located in El Segundo, California. We anticipate prioritizing this work to be completed during the coming year. At this time, we believe that it is premature to commit to perform a post quality review of this audit. Instead, we will ensure that this audit is subjected to a pre-issuance Independent Referencing Review. We believe that the additional guidance and training that we have provided to our workforce combined with an independent review is sufficient to ensure that sufficient testing is performed to support the audit opinion. This audit may still be selected for post quality review in accordance with existing Agency guidelines.

1.b. Concur in Principle. As noted in our December 22, 2010 response to your preliminary review results, we agreed to perform additional testing of direct material costs and direct labor costs prior to issuing a supplemental report on the 2004 (b) (4) incurred cost. Our additional testing is still in process and is scheduled for completion by June 30, 2012; however, we are continuing to assess our priorities to determine if the audit can be completed earlier. Given that a post issuance review had already determined that additional direct cost testing is required, once that additional testing is completed, we do not believe that another post quality review would serve a useful purpose unless it is selected in accordance with the Agency's post quality review procedures. We will ensure that this audit is subjected to a pre-issuance Independent Referencing Review. We believe that the additional guidance and training that we have provided to our workforce combined with an independent review is adequate to ensure that sufficient testing is performed to support the audit opinion.

1.c. Concur. Our Quality Directorate performed an assessment of the 2005 (b) (4) incurred cost audit, reference DCAA Memorandum Q 225.4, dated June 30, 2011. The quality review recommended rescission of the FY 2005 incurred cost audit. On August 5, 2011, CCBO issued a rescission memorandum to the original report recipients.

1.d. Concur. Our Quality Directorate performed an assessment of the (b) (4) 2004 incurred cost audit as noted in their June 30, 2011 memorandum, reference Q 225.4. The quality review confirmed that there was insufficient testing of direct and indirect labor costs, direct materials and ODC. The 2004 (b) (4) audit has not yet been completed and will be prioritized for completing during FY 2012. As noted above, the additional testing on the (b) (4) portion is scheduled for completion by June 30, 2012.

1.e. Concur. As previously noted, on June 15, 2011, all CCBO staff received training on the specific audit quality issues identified by the DoDIG. A copy of the training has been provided to the DoDIG.

1.f. Concur. As previously noted, over the last several months all Central Coast Branch Office employees have received significant training aimed at improving the overall audit quality within the FAO as well as across the Agency. In addition, we have clearly communicated our expectations to the workforce in regards to performing quality audits in accordance with

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Generally Accepted Government Auditing Standards. In our response to Finding A, recommendation 1.e., we provided a list of specific training received by the Central Coast Branch Office Staff all aimed at increasing audit quality. Lastly, the specific auditors and management staff who are still employed by DCAA and performed significant effort on this assignment have been specifically counseled in relation to those audits.

1.g. Concur. By October 2011, DCAA will review the performance of the management and staff involved in 3561-2004S10100001 and take appropriate actions to correct identified deficiencies. In addition, training will be provided to the FAO on the specific quality issues identified by the IG.

1.h. Concur. See response to Recommendation 1.g. above. DCAA will provide the applicable documentation upon completion.

2.a. Concur. As previously noted, on January 24, 2011, the Central Coast Branch Office notified the (b) (4) North Texas Resident Office that additional testing must be completed on the 2004 (b) (4) portion of the (b) (4) incurred cost audit. In addition, our memorandum noted that additional work may be required for the 2005 incurred cost audit as well. As the 2004 and 2005 (b) (4) incurred cost audits are still in process, contracting officer notification is not necessary at this time as the contracting officer was not on distribution of the 2004 and 2005 (b) (4) audit reports. These reports were only issued to the DCAA (b) (4) Resident Office.

2.b. Concur. As noted in our December 22, 2010 response to your preliminary review results, we agreed to perform additional testing of direct material costs and direct labor costs prior to issuing a supplemental report on the 2004 (b) (4) incurred costs. Our additional testing is still in process and is preliminarily scheduled for completion by June 30, 2012. However, as noted above, we are continuing to assess our priorities to determine if the audit can be completed earlier. Once completed, we will provide a copy of our report to your office.

2.c. Concur. As previously noted, our Quality Directorate performed an assessment of the 2005 (b) (4) portion of the (b) (4) incurred cost audit, reference DCAA Memorandum Q 225.4, dated June 30, 2011, and determined that additional testing is required. We are in the process of developing our program plan for FY 2012. We anticipate prioritizing this work to be completed during the coming year and anticipate that it will be completed by September 30, 2012.

3.a. Do Not Concur. As previously discussed, the 2004 and 2005 (b) (4) incurred cost claims are still under audit. As such, notifications are not required.

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3.b. Concur in Principle. As previously noted, our Quality Directorate performed a post quality review of the 2004 and 2005 (b)(4) portion of the (b)(4) incurred cost claim. The (b)(4) 2004 and 2005 incurred cost audits are still in process; therefore, a supplemental report would not be required. The Central Coast Branch Office is performing additional testing and will supplement their audit report prior to the issuance of the 2004 and 2005 (b)(4) audits. As previously noted, we anticipate completion of our additional 2004 and 2005 (b)(4) direct cost testing by June 30, 2012 and September 30, 2012, respectively.

3.c. Concur in Principle. As noted above, the 2004 and 2005 (b)(4) incurred cost audits are still in process. As such, no supplemental report is required; instead, the final reports will incorporate the additional testing performed by the Central Coast Branch Office on the (b)(4) portions of those claims.

FINDING G. POSTAWARD AUDIT SELECTION (ALLEGATION 13):

DoDIG Recommendation G:

1. The Director, DCAA:
 - a. Increase FY 2011 and FY 2012 defective pricing audit coverage at any office that did not complete the required number of audits for contractors with separate risk determinations.
 - b. Make appropriate revisions to the DCAA planning and audit guidance to ensure that the DCAA defective pricing program is providing adequate coverage on an annual basis.
 - c. Ensure all audit offices' defective pricing universes include intercompany or interdivisional transfers as required.
 - d. Revise defective pricing selection guidance to require that pricing actions subject to defective pricing remain in the universe for at least five planning periods instead of three.
 - e. Revise existing defective pricing selection process guidance on how long a pricing action should stay in the universe to include consideration of factors or risks other than the number of years already in the universe.
2. The Branch Manager, Central Coast Branch Office, Western Region:
 - a. Assign (b)(4) a separate risk determination during the defective pricing selection process.
 - b. Complete at least three postaward audits on (b)(4) pricing actions in FY 2011 and FY 2012.

DCAA Responses/Corrective Actions to Recommendation G:

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1.a Do Not Concur. As an Agency, we have had insufficient resources to address all the postaward audit requirements based the existing DCAA postaward audit requirements process. While DCAA recognizes the importance of performing post-award audits, we simply have not had the resourcing capacity to perform all the required audits per our guidance. As noted in response to 1.b. below, DCAA will re-assess our current postaward requirements process by March 2012. As we complete our plan for FY 2012, we will share our assessment as to which post award audits we anticipate completing next fiscal year. This assessment will be based on using the available resources on the highest risk pricing actions.

1.b Concur. By March 2012, we will re-assess our defective pricing program to ensure it is providing the appropriate coverage based on the available resources. For the past several years, DCAA has not had the available resources to perform the defective pricing audits in accordance with the DCAA planning and audit guidance. It is expected that this will be the same situation for FY 2012. For FY 2012, DCAA is planning to expend the limited resources to complete the higher risk defective pricing audits. Once the FY 2012 plan is finalized, we will provide the DoDIG with the listing of the higher risk defective pricing audits planned for completion in FY 2012.

1.c Concur in principle. By December 2011, we will issue an audit alert reminding FAOs to include intercompany and interdivisional orders in their defective pricing universes. We believe this will substantively accomplish the DoDIG recommendation to ensure all offices' defective pricing universes include intercompany or interdivisional transfers.

1.d Concur. On April 22, 2011, DCAA Headquarters issued MRD 11-OWD-016(R) Fiscal Year (FY) 2012 Requirements Plan Guidance which required that the pricing actions subject to defective pricing audits should remain in the universe for five years.

1.e Concur. As part of our re-assessment of the DCAA planning and audit guidance for defective pricing audits, we will re-assess the criteria for retaining pricing actions in the postaward universes.

2.a Concur. The (b) (4) North Texas Resident Office has audit cognizance over (b) (4) (b) (4) which includes the costs from (b) (4). The (b) (4) North Texas Resident Office is responsible for the assignment of a separate risk determination for (b) (4) during the defective pricing selection process.

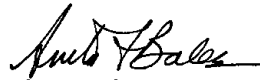
2.b Partially Concur. At this point, we do not have sufficient resources to add additional requirements for FY 2011 at our (b) (4) North Texas Resident Office or our Central Coast Branch Office. However, we are in the planning stages for FY 2012. We anticipate having sufficient resources to perform at least a portion of the (b) (4) post

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award audits required during FY 2012. Once we complete our plan, we will share a listing of the planned post award audits at ^{(b) (4)} [REDACTED] We expect to complete our FY 2012 program plan by September 30, 2011.

If you have any questions regarding this response, please contact Mr. Kenneth Saccoccia, Assistant Director, Policy and Plans at 703-767-3280.



Anita F. Bales
Deputy Director

Acronyms and Abbreviations

| | |
|----------------|---|
| DCAA | Defense Contract Audit Agency |
| GAGAS | Generally Accepted Government Auditing Standards |
| GAO | Government Accountability Office |
| IG | Inspector General |
| FAR | Federal Acquisition Regulation |
| DFARS | Defense Federal Acquisition Regulation Supplement |
| T&M | Time and Material |

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